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EMANUEL SAXE, *Managing Editor*

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VOL. XVI

July • 1946

No. 7

An Introduction to Major League Baseball Club Accounting and Auditing

By JAMES A. CURRAN, C.P.A.

THE impulse to call this article "Accounting for Major League Baseball Clubs" succumbs to the reflection that there is no accounting for some of them. To entitle it "Accounting and Auditing of Major League Baseball Clubs" leaves the writer fair game for critics who remember Ring Lardner's observation that "He wasn't a good hitter but he wasn't a good fielder." Occupational caution triumphs and the title becomes "An In-

troduction to Major League Baseball Club Accounting and Auditing".

A major league baseball club has one absolutely fundamental purpose. That is to build and maintain a squad that will beat the brains out of every other club in the league day after day and month after month. And then, in October, to take the other league's champ in the same way.

That simple and serious purpose should never be lost sight of, even though during the attempt to carry it out a number of other subordinate activities are pursued. There is an undeniable correlation between the standing of a club throughout the season and the size of the credit balances in those beguiling accounts — Home Game Admissions—Gross Receipts and Foreign Games—Club's Share of Receipts. So that while executives in other industries are guided by sales and production curves, the top men in baseball are studying club standings, batting and fielding averages, and reports from innumerable scouts on the prowl all over the country. Hardly a season goes by but the clubs receive from excited statisticians elaborate, new, and secret methods for rating players' talents and insuring, statistically speaking, year after year of champion teams.

JAMES A. CURRAN, C.P.A., has been a member of the Society since 1936. He was graduated from The College of the City of New York and also holds a master's degree from Columbia University. Mr. Curran is head of the accounting firm of Curran and Company in New York City and is a director of a baseball club. He has also been teaching accounting since 1931, in the evening session of The City College. This authoritative article by Mr. Curran, written somewhat in the breezy style in which baseball folk express themselves, opens the door to a field of accounting activity which has hitherto remained virtually unexplored.

Running a major league baseball club successfully is a tough business. Efficient operation requires making numerous decisions the value of which may not be tested for five or ten years. And then just as a prospective star is in the big leagues, after slow, careful nurturing from sandlot, high school, or college up through Class D, Class C, Class B, Class A, Class AA, and Class AAA, his arm goes lame, or he breaks a leg, or some blonde lass who makes a habit of sitting behind third base converts the lad into a bemused dolt. Sure, luck plays a big part in operating a major league club. But top business management, applying year after year the principles that enter into the conduct of America's powerful industrial giants will eventually minimize the element of luck in baseball. There is abundant reason for believing that the scientific management, taken for granted in the operation of top-flight corporations like du Pont, Western Electric, Ford, and others, will eventually, in baseball, bring about competition just as consistently expert.

The leading clubs now see to it that their minor league subsidiaries or affiliates are efficiently run, that their activities are profitably co-ordinated, that diligent scouting forces are systematically and persistently exploring every possible source of new manpower, and that each other activity of the organization, from negotiating with broadcasting companies to arranging players speaking engagements or appearances at churches, synagogues, and club socials, is tied to the absolutely fundamental purpose of keeping the team at the top of the heap. Attention to detail is as important, and pays off as well, in baseball as in banking.

Major league baseball clubs on Form 1120 give as their business serial number, #163, "Amusement, recreation, and related services (other than motion pictures)." Patrons of clubs that consistently finish in the second division may quarrel with the designation that associates amusement with

their teams' performances, but that is the description the Bureau finds fitting. A club's total income from baseball may be divided into home game receipts, foreign game receipts, training game receipts, and exhibition game receipts. And, every now and then, World Series games receipts. Other income producing activities, not necessarily in order of importance, are leasing the park for football games, contracting for the broadcasting privileges, sharing in concessionaire receipts, and renting the park for affairs as diverse, at first glance, as circuses and political campaign rallies. That the parks, representing huge investments, the principal balance sheet assets, are idle and unproductive for so much of the year is a problem to which baseball executives are giving increasing attention.

Income from the sale of players (actually from the sale of players' contracts) can be a very important factor in a club's financial showing. Many times a club avoids the red because of shrewd trading in players. That circumstance may explain why a consistently second division club shows profits year after year. In this connection, we have another example of good accounting practice yielding to the demands of income tax requirements. Good accounting practice would write off the cost of a player's contract over three or five years. But that method involves adjusting the club's income statement when the federal income tax return is prepared, since the Bureau requires that the cost of the contract be deducted as a business expense in the year in which such cost is paid or accrued. And, as a corollary, the entire consideration received for the sale of a player's contract is reportable as ordinary income.

Baseball front-office men will tell you that their business is different. Accountants accustomed to hearing the same declaration from businessman after businessman, will readily acknowledge that, at least in the matter of

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vocabulary, baseball is different. All fans are familiar with "blooper", "screwball", "cousin" and other fanciful words in baseball jargon. But the accountant has to understand the exact meaning of waiver, option, recall, release, ten year man, and a number of other terms peculiar to operation of a baseball club.

The rules regulating player contract transactions are intricate and inflexible, the product of many years of slow change and development. Rule 10, for example, of the Major League Rules controls waivers. Briefly its points are that after June 15th to the close of the championship season, no player contract shall be assigned to another club of the same league; or "at any time to a club of the other major league except after all clubs of the proposed assigner's league shall have had an opportunity to take an assignment of such contract at the waiver price . . ." Nor may a club assign a player's contract to a minor league club before giving each major league club an opportunity to take the man. There is an exception to the last stipulation in that within the first three years after the player has reported to the assigning club he may be sent back to the minors without having waivers granted. During the playing season claims for a player must be received within seventy-two hours after waivers have been requested. At other times the waiver period is seven days. And at all times the waiver price is \$7,500. In case of claim by any major league club, the assignor may within 48 hours after receipt of advice of such claim, revoke the waiver request.

Only last year Mr. McPhail sold Hank Borowy to the Cubs for a reported \$100,000 while the waiver price was \$7,500. The other American League club officials, to be sure, saw Borowy's name on the waiver bulletin; but, believing that were they to claim him at the waiver price the Yankee Club would revoke the waiver request

(as all clubs so often do) no American League club bothered to put in a claim. No doubt if any club had, the waiver request would have been withdrawn.

When a player, signed to a major league contract, is sent down to a minor league club, the assigning major league club, if it retains the option to recall, must pay to the player the difference between the salary called for in his contract and his salary with the minor league club. A major league club may not have more than fifteen optional agreements in force at one time. And such assignments are not permitted for more than three seasons in the case of any one player. When a major league club exercises its right of recall, it must pay the minor league club a consideration of \$500 (or such greater consideration as may be stipulated in the optional assignment).

A ten year man is one who, as the title indicates, has been in the major leagues ten years or more; he does not have to accept assignment to a minor league club. He is entitled to ask for his release and then, as a free agent to attempt to sign with any other club in either league.

Most major league clubs pay various minor league clubs, in which they have no financial interest, for the right to select one or more players each season. The minor league clubs in these arrangements are generally way down in the scale, below Class AA. Such payments are charged by the major league club to Development Expense, and are described as Minor League Right of Selection.

II

The following chart of accounts is, perhaps, in more detail than some clubs would find necessary. Eliminations and combinations will suggest themselves to the average accountant. Certain accounts, marked by an asterisk, are explained in the section following the chart.

CHART OF ACCOUNTS

- A. Assets
- L. Liabilities and Capital
- H. Income
- E. Expenses
- F. Other
- A. 100 First National Bank—regular account
- *A. 101 First National Bank—road account
- *A. 102 First National Bank—rain check account
- *A. 103 First National Bank—government admission tax account
- A. 104 First National Bank—scouting account
- *A. 107 Change account
- A. 108 Petty cash account
- A. 110 Government bonds and other marketable securities
- A. 115 Players' contracts receivable
- A. 116 Miscellaneous accounts receivable
- A. 117 Notes receivable
- A. 119 Guaranty deposits
- A. 120 Panther Baseball Club of Panther, Pa., Inc.—Investment
- A. 121 Panther Baseball Club of Panther, Pa., Inc.—Advances
- A. 122 Wolverine Baseball Club of Wolverine, N. C., Inc.—Investment
- A. 123 Wolverine Baseball Club of Wolverine, N. C., Inc.—Advances
- A. 130 Prepaid insurance
- A. 131 Prepaid property taxes
- A. 132 Other prepaid and deferred charges
- A. 140 Land
- A. 141 Buildings, grandstands, and bleachers
- A. 142 Field lighting equipment
- A. 143 Automobiles and trucks
- A. 144 Office furniture and fixtures
- A. 145 Sound equipment
- A. 146 Miscellaneous equipment
- A. 151 Reserve for depreciation of buildings, grandstands, and bleachers
- A. 152 Reserve for depreciation of field lighting equipment
- A. 153 Reserve for depreciation of automobiles and trucks
- A. 154 Reserve for depreciation of office furniture and fixtures
- A. 155 Reserve for depreciation of sound equipment
- A. 156 Reserve for depreciation of miscellaneous equipment
- *A. 160 Players' contracts
- *A. 161 Reserve for amortization of players' contracts
- *A. 162 Players' contracts—uncompleted transactions
- *A. 170 Franchise in the "Blank" League of Professional Baseball Clubs
- L. 200 Notes payable
- L. 201 Accrued interest payable
- L. 202 Accounts payable
- *L. 203 Government admission tax payable
- L. 215 Players' contracts payable
- L. 220 Accrued salaries and wages
- *L. 230 Rain checks unredeemed
- *L. 240 Advance ticket sales
- L. 250 Provision for federal and state income taxes
- L. 251 Provision for federal and state social security and unemployment taxes
- L. 252 Provision for city and local taxes
- L. 260 Mortgage payable
- *L. 270 Concessionaire deposit unearned
- L. 280 Capital stock
- L. 290 Earned surplus
- L. 295 Capital surplus
- L. 299 Profit and Loss
- H. 300 Home game admissions—gross receipts
- H. 301 Home game admissions—payments to visiting clubs
- H. 302 Home game admissions—payments to leagues
- H. 303 Home game admissions—season tickets
- H. 305 Foreign games—club's share of receipts
- H. 306 Training games—club's share of receipts

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- H. 307 Exhibition games—club's share of receipts
- H. 308 World Series—club's share of receipts
- H. 311 Football games—club's share of receipts
- H. 320 Other events—club's share of receipts
- H. 330 Income from broadcasting privileges
- H. 331 Income from park concession privilege
- H. 340 Interest and dividends on investments
- H. 341 Interest—other
- H. 345 Miscellaneous income
- E. 400 Game expense—controlling account—See analysis
- E. 401 Park operation expense—controlling account—See analysis
- E. 402 Park maintenance expense—controlling account—See analysis
- E. 403 Scouting expense—controlling account—See analysis
- E. 405 Training expense—controlling account—See analysis
- E. 406 Administration expense—controlling account—See analysis
- E. 407 Publicity and public relations expenses—controlling account—See analysis
- E. 408 Football game expenses—controlling account—See analysis
- E. 409 Exhibition game expenses—controlling account—See analysis
- E. 410 Other events expenses—controlling account—See analysis
- E. 411 Miscellaneous expenses
- E. 416 Amortization of players' contracts
- E. 451 Depreciation expense—buildings, grandstands, and bleachers
- E. 452 Depreciation expense—field lighting equipment
- E. 453 Depreciation expense—automobiles and trucks
- E. 454 Depreciation expense—office furniture and fixtures
- E. 455 Depreciation expense—sound equipment
- E. 456 Depreciation expense—miscellaneous equipment
- E. 460 Mortgage interest expense
- E. 461 Other interest expense
- *F. 500 Loss or gain on sales of players' contracts
- F. 505 Loss or gain on sales of plant equipment

The Road Account, operated as an imprest fund, is established for the use of the club's travelling secretary one of whose jobs it is to book all train or plane and hotel accommodations for the players, coaches, trainers, and, for newspapermen making trips with the team at the club's expense. Not all clubs, however, pay the newspapermen's expenses. The travelling secretary, generally a much put-upon gentleman, sees to it that baggage is taken care of, that the players are at the train in time, that hotel charges are accurate, and that players get advances against salary when needed. During the training season, the travelling secretary pays, from his road account, all expenses of the squad. During the playing season he may pay all travelling and hotel charges from his account; or the bills may be sent to the home office for payment.

If on a "rain day" the park is not opened to spectators the club transfers from the regular bank account to the Rain Check bank account the amount

that had been received on advance sales of tickets for that day. At the same time, an entry is made debiting Advance Ticket Sales account and crediting Rain Checks Unredeemed account. If the game is rained out after fans have been admitted to the park, the entire day's admission receipts are deposited in the Rain Check bank account and the Rain Checks Unredeemed account is credited.

Each day, the federal government's share of the admission price collected is deposited in a separate bank account called Government Admission Tax Account. Such taxes constitute trust funds. A concurrent credit is made to the liability account Government Admission Tax Payable. The tax is remitted to the government in the month following collection by the club which at the time of remitting files forms #729, and #729A, the latter an information return.

The Change Account, opened at the beginning and closed at the end of each home stay of the club, is used to record

withdrawals from the regular banking account of bills and specie needed each day by the ticket sellers when the gates are opened.

Only those clubs that adhere to orthodox accounting, in respect to transactions in players' contracts, will have the asset account *Players' Contracts* on their books. Those clubs keeping their books on the basis that conforms with income tax regulations will have, instead, *Players' Purchases*, an expense account, and *Players' Sales*, an income account.

The asset account *Players' Contracts* is charged with the cost of all contracts purchased. If more than one player be acquired for a single lump sum, and if the negotiations throw no light upon how the purchase price should be apportioned, it is generally sufficient to use an allocation furnished by the club's executive in charge of such transactions. In trades where a club gives up not only cash, but also other players to acquire a new man, the cost of the new man's contract is the sum of the cash paid for him plus the unamortized cost of the contracts of the players transferred. In a straight trade, with no cash involved, the man (or men) coming to the club is assigned the unamortized cost of contract of the man (or men) leaving the club.

Players' contracts should be written off over a period justified by the club's experience with the players. Three or five years seem fairly representative. It is important to calculate the amortization on a basis of the full playing schedule of 154 games per year. If, for example, a player be bought for \$38,500 the annual amortization charge by a club whose players have an average club span of 5 years would be \$7,700, a per game amortization of \$50. Interim statements are more reliable if amortization per game be known. And in the event of a trade during the season amortization up to the date of the trade has to be known and recorded.

The account *Players' Contracts—Uncompleted Transactions* is used to record payments made, generally to a minor league club, for a player who will not come up to the majors until the following season. There may be two or three payments made while the player continues with the minor league club, the final payment not being made until after the close of the major league season. Or there may be a stipulation that final payment will be made only if the player remains with the major league club for a certain time after the opening of the season following. Upon completion of the payments, the total purchase price is transferred to *Players' Contracts* and becomes subject to amortization.

Each major league club has a franchise from the league of which it is a member. Though the value assigned to the franchise is generally an arbitrary one, the balance of the account *Franchise* in the "Blank" *League of Professional Baseball Clubs* represents a valuable tangible as well as intangible asset since each club has a one eighth interest in the surplus of the league.

Rain Checks Unredeemed account, credited at the time of deposit in the *Rain Check* bank account, as described above, is charged when stubs are presented to the club for payment or for admission to a later game. If the stubs are redeemed by refund of the purchase price, the entry is a debit to *Rain Checks Unredeemed* and a credit to *Rain Check* bank account. If the rain check stubs are used for admission, the funds are transferred to the regular bank account and to the *Government Admission Tax Account* and an entry is made debiting *Rain Checks Unredeemed* and crediting *Home Game Admissions—Gross Receipts* and *Government Admission Tax Payable*.

The *Advanced Ticket Sales* account is credited at the time of receipt of funds for tickets to future games. On the days such games are played the account is charged and *Home Game Admissions—Gross Receipts* and *Gov-*

ernment Admission Tax Payable are credited. At the same time the tax funds relating to such tickets are transferred from the regular bank account to the Government Admission Tax Account.

Advance deposits made by the concessionaire before the season opens are recorded in the deferred income account Concessionaire Deposit Unearned. As concession privilege income is earned during the season, transfers are made to the account Income from Park Concession Privilege.

The principal income account Home Game Admissions—Gross Receipts is supported by a detailed analysis showing the receipts from the series with each of the seven other clubs. It should be noted that this account is not credited with the total amount received for each ticket, since the tax portion of the admission price, collected in trust for the government, is credited to the admission tax liability account. The balance in the Home Game Admissions—Gross Receipts Account must tie into the record of total tickets sold as will be described later in this article.

When the turnstiles are closed, generally along about the middle of the game, the visiting club's travelling secretary together with the home club's travelling secretary, takes a reading of each stile. This record is the basis of the settlement, on the last day of each club's stay at the park, which is charged to the account Home Game Admissions—Payments to Visiting Clubs. Here, too, the account is supported by a detailed analysis showing payments to each of the seven visiting clubs.

The League's share of each admission is based upon the same turnstile reading. Payments, made to the league at the end of each series, are charged to Home Game Admissions—Payments to League which account is kept in detail club by club.

Of the accounts relating to home game admissions only the Season

Ticket account is kept without detail as to visiting clubs. Usually the income from season ticket sales is of minor importance.

On the last day of each series away from home the club's travelling secretary receives from the home club a check for his club's share of the series receipts. Settlement is made on the basis of stile readings taken by the visiting club's secretary each day. These collections are credited to Foreign Games—Club's Share of Receipts.

The practice in most major league baseball parks is to grant the concession privilege to a licensee. Compensation to the club is generally payment of a share of the concessionaire's sales. The percentage which is the club's share varies with the ware or commodity sold, and may range from 10% to 50% depending upon the item sold. Each month the concessionaire pays the club its share of the preceding month's business. Such revenue, credited to the account, Income from Park Concession Privilege, is often sizeable, particularly in parks where soda pop is bought not only for quenching a thirst.

The operating and administrative expense accounts, functional controlling accounts, are supported by subsidiary accounts kept in such detail that operation under a budget program is a logical accompaniment. As the expense account analysis schedule shows, management requires an extensive breakdown of expenses. Game expenses, because of including players salaries, lead all the other control classifications in size. In turn the combined salaries of all groups constitute the largest expense, as high as two-thirds or three-quarters of total expenses. That circumstance points to an important phase in auditing a ball club's accounts.

III

Despite occasional efforts made to have the major league clubs adopt a uniform accounting system each club uses its own method of accounting, and

its own account nomenclature. The books of account and auxiliary records are likely to be:

- General ledger
- Subsidiary expense ledger
- General journal
- Standard journal
- Cash receipts book
- Cash payments book
- Petty cash journal
- Road secretary's cash journal
- Chief scout's cash journal

The records relating to tickets

Used, as the name indicates, to provide a detailed analytical record of functional expense controlling accounts, the subsidiary expense ledger is a loose-leaf, columnar page record upon which are distributed the many different expenses shown in the breakdown schedule accompanying the chart of accounts.

If interim statements are to have meaning, a baseball club has to break up its operating year into a number of periods of irregular length. This procedure is necessitated by the fact that in some months there is no income at all (from the close of football season until the beginning of the training games) while even during the championship season the income will vary widely from month to month depending on the number of games played at home and away in any one month. Comparative monthly statements are quite useless therefore.

One club's practice, involving the use of a standard journal, is to divide the year into seven periods. The current schedule provides the following division for 1946.

	League Games	
	At Home	Away
January 1-February 15..	—	—
February 16-April 15...	—	—
April 16-May 26.....	20	20
May 26-July 5.....	20	19
July 5-August 18.....	19	21
August 18-September 30.	17	18
October 1-December 31..	—	—

During the first period there is no income received, except possibly from the sale of players, and expenses are at a minimum. The second period starts with the beginning of the training season, marked by income from training games and by a sharp increase in operating expenses, and ends with the last training period game usually played at home. While the championship season is on, during the ensuing five and a half months, most of the club's income is received and most of its expenses are paid. During that period 154 games are scheduled and the clubs alternate four stretches in the East with four stretches in the West. Or depending on the club, with four stretches at home and with four swings into eastern or western territory.

It is a simple matter to divide the playing season into four periods each containing approximately the same number of games at home, and games away. Since the leagues' schedules have become standardized interim statements based on such a four period division of the playing season provide useful comparisons both of periods within the season and year after year.

To adapt the bookkeeping system to the need for interim statements, it is helpful to use a standard journal for accurate allocation of predeterminable expenses to the periods. Since the periods will each include a different number of days, the object during the championship (i.e. league) season being to break up the 77 home games into four periods each containing approximately the same number of home games, the standard journal is an almost indispensable part of the bookkeeping procedure. Expenses related to games both at home and away, players' salaries and contract costs, for example, are broken down, by division by 154, into units of a single game. While expenses related solely to home games, such as park operation and maintenance expenses, are divided

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by 77 to get a unit charge per home game.

The most important record underlying the conventional books of account is the Daily Game Statement. This record provides a detailed analysis of each day's ticket sales, showing quantities of each kind of ticket sold and the cash receipts, also by type of ticket sold. It is a record of fundamental importance not only to the management but also to the auditor of the club's accounts.

The vertical column headings of the Daily Game Statement may be:

- Kind of Ticket
- Tickets Received
- Tickets Returned
- Tickets Sold
- Rain Checks Cashied
- Net Tickets Sold
- Stile Number
- Stile Record
- Sale Price
- Government Tax
- Total—Club Cash
- Total—Government Tax Cash

On the Daily Game Statement there is one horizontal line for each stile number, and there are sections for grouping and sub-totaling the various kinds of tickets sold. Space is provided at the foot of the sheet for various recapitulations and divisions of receipts among visiting club, the league, and the home club. The total government tax collected is shown and deposited separately.

The Daily Game Statement is posted from the Daily Ticket Seller's Statement, which is prepared in duplicate by each ticket seller. In addition to containing the information posted to the Daily Game Statement, each Ticket Seller's Statement records the serial numbers and ticket numbers of the tickets received, sold, and returned, by the seller each game.

Affording a check upon the ticket sellers record is the automatically printed turnstile record. The turnstile register can be turned back to zero each day, or it can be allowed to accumulate totals. In the latter case, of course, the day's turnstile record of admissions is computed by subtracting the opening total from the closing total.

Over-all ticket control is kept by means of a Ticket Inventory Register, a loose-leaf book, with its pages ruled in various ways for each kind of ticket. Columns are provided for opening inventory, with each serial group or block number listed on a separate line, for purchases, for dates of withdrawals, for withdrawals for returns to inventory, and for "to be destroyed." All unsold box and reserved seat tickets, since they are pre-dated, are marked for destruction after the playing season. Also marked "to be destroyed" are small unsold irregular quantities of grandstand, bleacher, and other strip tickets. The ticket Inventory Register is posted to from the printer's manifests (for purchases) and from the Daily Ticket Sellers Statement (for sale).

It is to be noted that the bookkeeping machine and cash register companies are prepared to adapt their equipment to the ticket problems of baseball clubs.

IV

As the accompanying illustrative pro-forma statements show, the principal financial statements of a major league baseball club contain little that is novel in either content or principle. Though the statements shown are not consolidated, most clubs today operating extensive farm systems prepare consolidated statements. Of the many supplementary analyses prepared the comparative annual breakdown of attendance and receipts, showing averages, is the most popular and suggests the nature of the others.

	Game Expenses	Park Operation Expenses	Park Maintenance Expenses	Scouting Expenses	Training Expenses	Administra- tion Expenses	Publicity and Public Relations Expenses	Football Game Expenses	Exhibition Game Expenses	Other Game Expenses
Electricity and lighting.....		X				X		X	X	X
Heating		X				X				
Gas		X								
Water			X			X		X	X	X
Loam, sod, fertilizer, seeds, etc.....			X							
Janitor's supplies, etc.....		X								
Towel supply, laundry, etc.....	X				X					
Players options—sales and repurchases.....				X						
Accounting, auditing, and other professional services						X				
Stationery and office supplies.....					X	X				
Telephone and telegraph.....	X			X	X	X	X			
Postage	X			X	X	X				
Subscriptions and dues.....				X		X	X			
Gifts and donations.....				X		X	X			
Stenographic services	X			X	X	X				
*Development of players.....				X						
Payments to outside scouts.....				X						
Maintenance of buildings, grandstands, etc..			X							
Maintenance of equipment, etc.....			X							
Supplies, small tools and equipment.....			X							
Property taxes			X							
Federal social security taxes.....	X	X		X	X	X	X	X	X	X
State social security taxes.....	X	X		X	X	X	X	X	X	X
Other taxes						X				
Advertising							X	X	X	X
Miscellaneous	X	X	X	X	X	X	X	X	X	X

* Sometimes shown as a separate controlling account.

	Game Expenses	Park Operation Expenses	Park Maintenance Expenses	Scouting Expenses	Training Expenses	Administra- tion Expenses	Publicity and Public Relations Expenses	Football Game Expenses	Exhibition Game Expenses	Other Events Expenses
Players salaries	x									
Coaches salaries	x									
Trainers & clubhouse employees salaries...	x				x					
Scouts salaries		x		x	x			x	x	x
Ticket takers, attendants, ushers, etc. salaries					x			x	x	x
Ground keepers salaries			x							
Maintenance crews salaries										
Officers						x				
Office and clerical						x	x			
Transportation	x			x	x	x	x			
Hotels	x			x	x	x	x			
Meals	x			x	x	x	x			
Taxicabs	x			x	x	x	x			
Baggage	x			x	x	x	x			
Entertainment				x	x	x	x			
Beverages										
Baseballs	x				x					
Playing equipment	x									
Uniforms	x	x								
Cleaning uniforms, laundry, etc.	x	x		x	x	x				
Medical attention	x	x								
Clubhouse supplies	x	x			x			x	x	
Admission tickets		x								
Bands and decoration		x								
Licenses and permits		x						x		
Liability and compensation insurance		x				x		x	x	
Fire insurance										
Players life and accident insurance			x			x				
Other insurance						x				

The New York Certified Public Accountant

**THE "BLANK" LEAGUE BASEBALL COMPANY
COMPARATIVE BALANCE SHEET**

December 31, 1945 and December 31, 1944

	Dec. 31, 1945	Dec. 31, 1944
ASSETS		
Current assets		
Cash in bank and on hand.....	xxx	xxx
Notes and accounts receivable.....	xxx	xxx
United States bonds.....	xxx	xxx
Other Marketable securities.....	xxx	xxx
Total current assets.....	xxx	xxx
Player contracts	xxx	xxx
Less: Reserve for amortization.....	xxx	xxx
Plant assets	xxx	xxx
Less: Reserves for depreciation.....	xxx	xxx
Investments in and advances to controlled or affiliated baseball clubs	xxx	xxx
Franchise—The "Blank" League of Professional Base- ball Clubs	xxx	xxx
Deferred charges and other assets.....	xxx	xxx
Total assets	xxx	xxx

LIABILITIES		
Current Liabilities		
Notes payable	xxx	xxx
Accounts payable	xxx	xxx
Accrued taxes payable.....	xxx	xxx
Accrued expenses payable.....	xxx	xxx
Rain checks unredeemed.....	xxx	xxx
Total current liabilities.....	xxx	xxx
Deferred credits	xxx	xxx
Mortgage payable	xxx	xxx
Total liabilities	xxx	xxx

CAPITAL		
Capital stock	xxx	xxx
Capital surplus	xxx	xxx
Earned surplus	xxx	xxx
Total capital	xxx	xxx

An Introduction to Major League Baseball Club Accounting and Auditing

**THE "BLANK" LEAGUE BASEBALL COMPANY
COMPARATIVE STATEMENT OF OPERATIONS**

For the Years Ended December 31, 1945 and December 31, 1944

	Year Ended Dec. 31, 1945	Year Ended Dec. 31, 1944
Operating income		
Home games—gross receipts (exclusive of admission tax)	xxx	xxx
Less: Visiting club's share.....	xxx	xxx
"Blank" League's share.....	xxx	xxx
Net receipts from home games.....	xxx	xxx
Foreign games.....	xxx	xxx
Training games.....	xxx	xxx
Exhibition games.....	xxx	xxx
Total income from baseball.....	xxx	xxx
Other income		
From football games.....	xxx	xxx
From park concession.....	xxx	xxx
From broadcasting.....	xxx	xxx
From miscellaneous events.....	xxx	xxx
Total operating income.....	xxx	xxx
Expenses		
Operating and administrative expenses.....	xxx	xxx
Amortization of player contracts.....	xxx	xxx
Depreciation of plant assets.....	xxx	xxx
Gain from operations.....	xxx	xxx
Other income		
Interest and dividends.....	xxx	xxx
Gain on player contracts sold.....	xxx	xxx
Miscellaneous	xxx	xxx
	xxx	xxx
Other charges		
Interest	xxx	xxx
Loss on player contracts sold.....	xxx	xxx
Miscellaneous	xxx	xxx
Net profit before provision for federal income tax....	xxx	xxx
Provision for federal income tax.....	xxx	xxx
Net profit after provision for federal income tax....	xxx	xxx

**THE "BLANK" LEAGUE BASEBALL CLUB
COMPARATIVE OPERATING STATISTICS**

For the Years 1945, 1944 and 1943

	1945	1944	1943
Number of home games (See note).....	77	79	75
Total attendance.....	xxx	xxx	xxx
Gross receipts.....	\$xxx	\$xxx	\$xxx
Averages per game			
Attendance	xxx	xxx	xxx
Receipts			
Visiting club's share.....	\$xxx	\$xxx	\$xxx
"Blank" League's share.....	xxx	xxx	xxx
Home club's share.....	xxx	xxx	xxx
Average receipts per game.....	\$xxx	\$xxx	\$xxx
Averages per paid admission			
Visiting club's share.....	\$xxx	\$xxx	\$xxx
"Blank" League's share.....	xxx	xxx	xxx
Home club's share.....	xxx	xxx	xxx
	\$xxx	\$xxx	\$xxx

Note: More often than not a club does not play at home the 77 games scheduled there. Games cancelled by rain too late in the season to be made up by doubleheaders are played away from home. The reverse is also true with rained out foreign games being played at home whenever possible toward the end of the season.

V

Apart from the troublesome problem of tickets, auditing the books of a major league baseball club is similar to that of any business in which inventories are not an income-determining factor.

Verification of the balance sheet proceeds without any requirements not customarily met with in the conventional audit. A possible exception is the verification of the balance sheet value of players purchase contracts, which are stated at cost less amortization. Here inspection of each contract is accompanied by preparation of a schedule showing the year's and the accumulated amortization. Complica-

tions arise in cases where more than one player is acquired for a lump sum; or in a trade involving several players. On the player or players leaving the club amortization is computed up to the day of the trade, and the remaining unamortized value is apportioned over the incoming men. The opinion of the club's executive in charge of trades is sufficient authority for allocation.

In the audit of tickets there are three initial steps of the utmost importance. They are to secure an accurate count of the tickets on hand at the close of the preceding year; to have a complete seating plan of the park; and to have the club's printer send directly to the

An Introduction to Major League Baseball Club Accounting and Auditing

auditor copies of manifests covering all tickets ordered for the season.

Apart from emergency sets, there will be no box or reserved seat tickets on hand at the end of the club's fiscal year. Since these two types of tickets are printed for use during only a single season, any tickets remaining at the close of the season are destroyed. Carried forward from year to year are the following classes of tickets, generally serially numbered strip tickets (i.e. in fanfold or rolls, one ticket attached to another)

Grandstand
Bleachers
Ladies
Children
Tax
Exchange—bleacher to grandstand
Exchange—grandstand to reserved
Exchange—grandstand to box
Exchange—reserved to box

Emergency sets of reserved and box seat tickets will also be found in the year-end inventory. They are printed without date or game number and are used on days when the club wants to increase the sections of such seats beyond the original estimate for which pre-dated tickets have been ordered.

During the year, before the audit is begun, the auditor should keep a Ticket Inventory Register which is, actually, a duplicate of that kept by the club. Then when he begins his audit he will have in his working papers the opening inventory of tickets carried forward from the preceding year; and the total tickets bought during the year posted, classified, and compiled from the manifest copies received directly from the printer.

In an audit program, the foregoing might be stated in the following way.

- | Tickets | Work done by |
|---|--------------|
| 1. Post the manifests, received directly by us, to the ticket inventory record sheets (in duplicate, one copy being for the Treasury Department's representatives) .. | |

- | | |
|---|-------|
| (a) Make only one entry on each line of the ticket inventory record sheets | |
| (b) Enter box and reserved sheet tickets in chronological order | |
| (c) Prove the totals for each type of ticket purchased to the manifest totals | |
| (d) Prove the inventory figures carried forward from the preceding year in total for each type of ticket..... | |

At the park as soon as possible after the last home game has been played, the auditors continue their ticket program and begin simultaneously the important detailed analysis of the Daily Statement. This analysis of cash received and tickets sold must tie-in with the independently kept record of ticket sales entered in the Ticket Inventory Register. Perhaps the following excerpts from an audit program will show how the two audit operations mesh.

- | Tickets | Work done by |
|--|--------------|
| 2. Post the sales of all types of tickets to our ticket inventory record sheets from the ones kept by the club | |
| 3. Calculate the balances remaining and enter the balances either in the "to be destroyed" or the "restored to inventory" column.... | |
| 4. Count tickets to be destroyed, before destruction, to the extent of games; and % when the total tickets to be destroyed after a particular game are not counted | |
| 5. Witness the destruction of all tickets to be so treated..... | |
| 6. At all times during the counting keep the tickets under our control | |
| 7. Count tickets restored to inventory by blocks (serial groups) in total and individually to % of the total..... | |
| 8. As soon as it is known when the ticket proof will be completed as to cash, notify the club treasurer so that he can arrange to have Treasury Department representatives at the park for their count | |

and their witnessing of destruction of tickets.....

9. Prepare summary of all types of tickets sold which should be proved to the totals per our Cash Receipt and Ticket Sales Proof sheets. (These C. R. and T. S. Proof sheets are the 18 column sheets prepared from the club's Daily Statements.)

Daily Statements

1. Compare with cash book receipts for days weeks months
2. Add (as to \$) for days weeks months
3. Add (as to ticket quantities) for days weeks months
4. Trace from ticket sellers Ticket Statements for days weeks months
5. Trace from turnstile record slips for days weeks months
6. Add ticket sellers Ticket Statements as to money and ticket quantities for days weeks months
7. Post from Daily Statements, by clubs, all information needed to complete Cash Receipts and Ticket Sales Proof sheets.....
8. Prepare over-all recapitulation sheet of Cash Receipt and Ticket Sales Proof sheets.....
 - (a) Prove to summary of tickets sold per item #9 under Tickets
 - (b) Secure satisfactory explanations of any differences.....

As step #4 of the ticket audit procedure indicates, not all the unsold tickets to be destroyed are counted. Thorough sample or test counts are made with the Treasury Department's representatives joining forces with the auditor and his assistants in the counting. Occasionally all the unsold tickets remaining after a particular game will be counted; or for games of other days each counter will spot check two or three packs of 100 tickets; or all blocks

of irregular or broken quantities will be counted. The business of counting tickets may take several days and the auditor will have to take precautions, such as sealing the ticket vault overnight, that insure his tight control of tickets from the beginning of the count until the end.

Every few years, without, of course, giving any advance notice to the club, the auditor should increase the number of his assistants and make a complete count of all tickets, those to be destroyed as well as those returned to the inventory in the vault.

Supplying the Treasury Department's representatives with a duplicate of the auditor's copy of the club's over-all ticket inventory control sheets will be found to be of considerable practical advantage during the hurly-burly of the counting days. And experience confirms that when such a copy is furnished the revenue agents, their necessary clearance certificate is more promptly received.

Tickets are destroyed either by a shredding machine through which they run interminably; or by delivery to a bank, from which, after the burning of the tickets an incineration certificate is received. Not until the last ticket has been shredded or burned does the auditor dare to breathe a sigh of relief.

Whatever examination the auditor makes of the road or travelling secretary's accounts and bills, will be facilitated if the secretary has had prepared and approved in advance of each trip typed or mimeographed lists of all players, coaches, trainers, newspapermen, and others, who are to make the trip at the club's expense. Such lists will be of great assistance to the auditor in checking the bulky hotel and railroad bills. Though ballplayers do not occupy any more space in hotels than average citizens do, it does seem that they eat a great deal more.

Accounting for Consumer Cooperatives

By LOUIS ENGLANDER, C.P.A.

THE steady growth of consumer cooperatives in the United States has made them an important factor in the field of retail distribution. It is estimated that over two and a half million families are affiliated with cooperatives in the United States.

A consumer cooperative is an organization of patrons or members of a business enterprise who band together for the purpose of supplying themselves with commodities or services at cost. It should be differentiated from producers' cooperatives and from farmers' cooperatives which have other purposes or privileges.

The fundamental principles and methods of cooperatives affect accounting theory when applied in this area, and serve as a guide to the accounting practice. These principles and methods are:

The Primary Principles:

- (1) A consumer cooperative society shall be democratically controlled.
- (2) There shall be open membership.
- (3) Investments in a cooperative society shall return a fixed rate of interest which shall not exceed the current interest rate.

LOUIS ENGLANDER, C.P.A., and a member of the Society since 1934, is a partner of Apfel and Englander, C.P.A.'s. He has been active in the field of consumer cooperatives for many years. He is a lecturer at Rochdale Institute, the college maintained by consumer cooperatives, and also at The School of Business and Civic Administration of The City College, where he will conduct a course on Accounting for Consumer Cooperatives next semester.

- (4) Any net savings shall be returned to the customers who patronize the society on the basis of the amount of purchases.

The Methods (or Secondary Principles):

1. A cooperative society shall be composed of members who join voluntarily.
2. Business shall be done for cash.
3. Non-members may become members by permitting their share of the net savings to be applied toward their initial share investments.
4. A portion of net savings shall be used for educational purposes in the field of cooperation.
- *5. Goods and services shall be sold at prevailing market prices.
6. Adequate reserves shall be set aside to cover unforeseen difficulties arising in the operation of the business.
7. Labor shall be fairly treated.
8. Cooperative societies shall cooperate with one another.

Ordinary accounting theory is immediately affected by several of these principles. Democratic ownership in a consumer cooperative means control by membership rather than by the number of shares of stock owned. Regardless of the number of shares owned, each member has one vote. Open membership implies setting the value of a share of stock at a low enough price to permit any person to enter. (The par value of stock is set usually at \$5.00 or \$10.00.)

The principle of compensating invested capital at a fixed interest rate is a startling departure from the theory of dividends. Considered with the principle of rebating earnings to patrons on the basis of patronage, it presents a radical change from ordinary theory of the division of profits. Many

societies advocate a further change. In ordinary theory, all undistributed profits are transferred to a surplus which belongs, pro-rata, to shareholders. In cooperatives, the transfer is made to a General Reserve, which is considered to be social capital, belonging to the group as a whole and not inuring to the benefit of individual members. (While this concept is advocated, it has not been accepted generally by all cooperatives.)

Several of the methods, or secondary principles of cooperatives, affect their accounting practices. Business on a cash basis; part payment towards purchase of stock; reserves for education and contingencies; mutual cooperation among cooperatives; all have their influence upon the accounting system, and upon recording procedures. More elaborate corporate records must be prepared. A clear definition of educational expenditures and activities must be understood and stated. The need for a greater capital investment is compelled by mutual cooperation with other cooperatives.

The principle of cooperation among cooperative enterprises has brought about an interesting vertical structural development. A group of independent cooperatives of an area organize a regional wholesale, which serves the group. The regional wholesales organize a national wholesale to secure merchandise and to insure volume purchasing.

In the field of cooperative education and training, a similar development has been accomplished. The local societies organize a federation which studies the problems of the area. The federations band together into regional leagues which take in a number of states. The regional leagues are all part of the Cooperative League of the United States.

Consumer cooperatives believe their principles are so different from those of ordinary business that their accounting nomenclature should express clearly and accentuate these differences. A

committee of the National Society of Cooperative Accountants has been at work preparing a set of accounting terms for cooperatives. Many of these terms are unchanged, but explanatory sentences are frequently added to simplify them for cooperators unfamiliar with accounting practices. Some of the proposed changes follow:

Balance Sheet:

1. *Balance Sheet* is used with the parenthetical title, *Statement of Assets, Liabilities and Net Ownership*.
2. *Assets* are explained as *What We Have*; *Liabilities* as *What We Owe*.
3. *Allowance for Bad Debts* and *Allowance for Depreciation* are used; the term *Reserve* is used only in the Member Equities section.
4. *Member Equities*, with the explanation *What We Own* is substituted for *Capital*.
5. *Fully Paid Shares* or *Share Capital* is proposed instead of *Capital Stock*.
6. *General Reserve* is used instead of *Surplus*.
7. *Undistributed Savings* is used instead of *Undistributed Profit*.

A number of special reserves are in use. *Patrons' Equity Reserve* represents the amount of undistributed savings belonging to patrons, based upon their patronage during a given accounting period. Usually this amount remains with the society until liquidation. Of course records are kept of the patrons to whom this reserve belongs.

Deferred Patronage Refunds represents amounts set aside for patrons, payment of which is deferred to a future known period. Usually these refunds are liquidated before the payment of any subsequent patronage refunds.

Accounting for Consumer Cooperatives

A form of Balance Sheet is appended.

Operating Statement:

- (1) *Operating Statement* is preferred over *Income & Expense Statement*. *Statement of Profit & Loss* is definitely taboo.
- (2) There has been much discussion over the term which would best signify the money deposited by patrons for their purchases. The latest suggestion is *Sales at Provisional Prices*.
- (3) *Gross Margin* is used instead of *Gross Profit*.
- (4) *Store Expenses* or *Operating Expenses* is used to designate all selling, administrative and general expenses.
- (5) *Store Margin* or *Operating Margin* is used to denote the difference between *Gross Margin* and *Store Expense*.
- (6) *Other Savings* is used instead of *Other Income*.
- (7) *Undistributed Margin* or *Undistributed Savings* is used to denote the difference between *Store Margin*, *Other Savings* and *Other Expenses*.

A form of Operating Statement is appended.

Distribution of Savings:

- (1) *Interest on Share Capital* is used instead of *Dividends*.
- (2) *Patronage Refund* or *Patronage Savings Return* is unique with cooperatives. It is used to denote the amount of savings returned to patrons.

Accountants for cooperatives are still attempting to decide upon a terminology which, while conforming to general accounting terms wherever possible, will give effect to the cooperative principles and more clearly describe the nature of the account by the term used.

Accounting Procedures

Aside from procedures necessitated by the principles heretofore described, accounting for cooperatives is similar to the usual accounting for a cash retail business. The books of account are the cash receipts and cash disbursements journals, the purchase journal, the general journal, and in some cases, the sales journal. The general ledger and the membership ledger are the books of secondary entry. In lieu of a plant ledger, most cooperatives detail expenditures for fixed assets in the general ledger account. The membership ledger corresponds to the stock ledger, but usually contains more information. All transactions affecting stock ownership are reflected in this ledger. Not only cash payments for stock purchases are recorded, but also interest on share capital, total patronage with the society, and the amount of patronage refunds.

The principal primary records are the daily cash reports and invoices from suppliers. The daily cash report summarizes all cash receipts for the day. A cash register records individual sales and receipts. The register has several totalizers, so that receipts can be departmentalized. It has also a total bar, which accumulates all amounts rung upon the register. This total bar has a separate control key, so that it cannot be turned back except by the person who has control of the key. All other totalizers are automatically turned back to zero when the record of the day's transactions is taken.

The daily cash report is prepared by the manager and the cashier. The manager's function is to take off the departmental totals and calculate the amount of cash which should be on hand. The cashier counts the cash and turns it over for deposit. Any difference between the cash accountability and the cash count is recorded as cash over or cash short. Any difference of more than one dollar is traced. The report is then given to the bookkeeper for entry into the cash receipts journal, which is

columnarized to record all sources of receipts.

In some cooperatives, the managers are permitted to pay for small purchases and petty expenses out of the cash taken in. This practice is not recommended, and is rapidly disappearing. Such payments are more usually made from a petty cash fund.

Purchase invoices are entered in a purchase journal, which is kept ordinarily in the form of a voucher register. No accounts payable ledger is kept. It is cooperative policy to buy for cash as well as to sell for cash. Most bills are paid within the week. The purchase journal is columnarized to record departmental purchases and expenses. Payroll and petty cash replenishments are controlled through the purchase journal.

Entries in the journals are summarized at the end of the calendar week nearest the end of the month. Each quarter will have one five week period and two four-week periods. The summaries are posted to the general ledger, and a trial balance is taken.

Most cooperatives prepare quarterly reports, although a fair number prepare monthly reports. Interim inventories are taken. In grocery departments these are usually taken at retail and reduced to cost by applying a fixed mark-on percentage.

Cooperative reports include the customary Balance Sheet and Operating Statement. These reports are prepared in comparative form, and percentages are indicated thereon. A report for a quarter will always compare the current operations with those of the corresponding quarter of the previous year. Percentages of cost of goods sold, gross margin and expenses, are included as integral parts of the report.

The Balance Sheet form is similar to that of ordinary commercial Balance Sheets, except for the explanatory remarks previously mentioned. The Operating Statement differs in the segregation of expenses. After the

gross margin section, store expenses are listed in four groupings: Payrolls, Delivery, Occupancy, and General Store Expenses. The Payroll section includes all salaries and wages (except delivery salaries), provision for vacations and social security taxes. The Delivery section includes delivery salaries, provision for vacations, social security taxes, depreciation on delivery equipment, and other delivery expenses. The Occupancy section includes rent (or its equivalent), light, heat and power. All other store and administrative expenses are included in the last section.

Other Income and Other Deductions are called Other Savings and Other Expenses. Two types of Other Savings require special explanation. Just as each cooperative refunds part of its savings to patrons, so it in turn receives patronage refunds from the cooperative wholesale associations it patronizes. These patronage refunds received are included in Other Savings (on a cash basis) and are not applied as a reduction of cost of goods sold. In many cooperatives, the society contracts with some outside agency for a particular type of service to be rendered to its members—such as fuel purchasing, milk delivery, laundry service. For this, the cooperative receives a commission, which is included in Other Savings.

Net earnings on interim reports are referred to as "Net Savings, before Patronage Refunds and Federal Income Taxes." While a few states require cooperatives to declare patronage refunds quarterly, most refunds are declared annually, at the annual membership meeting. Boards of Directors recommend a rate of patronage refund, which is no greater than the rate earned on sales.

Integral parts of the report are the analysis of the Balance Sheet and the Operating Statement. Several standard relationships are usually discussed: The working capital and working capital ratio; the adequacy of

Accounting for Consumer Cooperatives

working capital; the ratio of merchandise inventory to current assets; the ratio of facilities (fixed assets and investments in cooperatives) to invested capital; the turnover of capital. Improvement or retrogression is noted and commented upon; causes and remedies are discussed. Operating percentages are of particular importance. Gross margins, by departments, receive the most detailed attention. Variations from the ordinary become the subject of careful study. While percentages of each expense are examined, the group expenses are watched carefully—payroll, delivery, occupancy and general store expenses. Not only are these group percentages compared with previous performances of the society, but they are compared with corresponding averages of all cooperative societies of the area, and with percentages of comparable individual societies.

This care and attention to the operating percentages is essential because the average net savings of retail food stores is less than 2% of sales.

Education expense, in amount, is comparatively significant. In type, it corresponds to institutional advertising and corporate meeting expenses. But cooperative education, in principle and in its effect on internal control, is extremely important.

The education function combines factors both general and specific. The general function proposes the teaching of cooperation to all who care to learn. Groups are organized to study the history, principles and philosophy of consumer cooperation. Speakers, prominent in the work, lecture on particular phases of cooperation. The specific function proposes the teaching of general store operations. This is done by means of literature on merchandising, control, finance; by the organization of committees of members to supervise (or advise on) the various activities of the cooperative society. Among these committees, the more important are (a) the membership committee; (b)

the store committee; (c) the inventory committee; (d) the auditing committee.

The membership committee, besides attempting to secure new capital, must know enough of each phase of the cooperative enterprise to give at least a summary statement of its principles and practices to the prospective member investor.

The store committee (or committees) checks on store merchandising, pricing policy and store management. This committee will report on anything from a not-too-clean store to comparative prices of commercial competitors. It works with management but functions through the Board of Directors. A live store committee can assist greatly in the creation of a live store.

The inventory committee is charged with the task of assisting in the taking, pricing, and computation of inventories.

The audit committee examines any records it desires in the interim periods prior to independent audits. Specifically, it checks total sales as indicated by the total bar of the cash register. It counts cash at the close of any period. It has the power to call for and examine any invoices from suppliers. This committee usually has the sole authority to turn back the total bar of the cash register to zero. It certifies the register readings and the cash counts to the independent auditor.

In addition to these committees, the treasurer is more than a mere figurehead. He is responsible for the control of cash. He receives duplicate deposit slips, bank statements, vouchers for disbursements, which he scrutinizes before signing checks. Of course, the larger the cooperative, the more the detail work will be performed by a paid employee under the treasurer's jurisdiction. In many instances, the bookkeeper works very closely with the treasurer.

These committees assist the auditor to a great degree. Their activities give an interim control upon which the

auditor may rely to a great extent. But it does not mean the auditor may eliminate the examination of internal check procedures. The cash and purchase procedures still require examination and audit.

Cash procedures are simplified by the use of the cash register. Members and patrons know their patronage refunds are dependent upon the cash register sales slips they receive at the time of the sale. Hence, no employee would dare to make a sale without ringing it upon the register. Daily deposits (with duplicate deposit slips going to the treasurer) and no "payouts," are important factors in control of cash receipts.

Cash disbursements control is aided once again by the treasurer and the audit committee. In many cooperatives the treasurer is a co-signer of all checks. He is supposed to receive the voucher with the check he is to sign. While he cannot examine in detail all vouchers, he can and usually does scrutinize most of them. The audit committee follows through monthly, by testing vouchers. Petty cash expenditures are usually made from an imprest fund. Payrolls are checked and prepared by store managers.

Purchase procedures include the weekly order to the cooperative wholesale association. Approximately half of all purchases are made through this source, and standardized order forms are used. Upon receipt, merchandise is checked for condition, quantity, price, and invoices for extensions. In many of the larger cooperatives, a receiving record is used to record all packages received daily (or weekly).

No perpetual inventory records are kept, nor are they generally necessary. In normal times the inventory turnover of groceries is 17 turns annually. The gross margin figures obtained monthly or quarterly serve as an additional check upon purchases and inventory, since the percentage must remain fairly constant.

Cooperative principles require frequent financial reports to be given to membership. Most cooperatives by-laws require independent audits. But membership is not customarily the type which can read and interpret financial statements. Pamphlets have been prepared which attempt to explain the technical language of accounting in simple terms, pictures, and diagrams.

"Learning the Language", the first of these pamphlets has had an extraordinary distribution and has been received and read avidly. To the present, seven such pamphlets have been prepared dealing with accounting, interpretation of financial statements, and cooperative finance.

As a result, the auditor is necessarily an analyst, and takes on the function of a comptroller. Reports must be prepared so as to be understood easily. These reports are always in comparative form, so that position and operating results can be compared with prior periods. Report forms must be more or less standard, so that one cooperative society may compare its results with another, and so that statistical information may be comparable. The ordinary reports are the Comparative Balance Sheet, Comparative Reconciliation of Surplus (in small cooperatives, the two are combined) and the Comparative Operating Statement.

Considerable experimentation is going on with the purpose of simplifying and interpreting statements. A modification of the Statement of Application of Funds which eliminates technical terminology is gaining popularity. A statement showing what happens to the dollar investment is also being tried.

Consumer cooperatives are subject to the same federal taxes as any commercial enterprise. Under certain conditions, patronage refunds paid may be deducted from sales in calculating net income subject to taxes. These conditions vary in different states, and are

Accounting for Consumer Cooperatives

dependent upon state laws. Where patronage refunds, based upon purchases, are given to *all patrons*, in a percentage no greater than that earned for the period, the refunds are allowable deductions from sales. Some state laws require a lesser rate of refund to be paid to non-member patrons. In such states, if the provisions of the state law are being carried out, the refunds are allowable deductions from sales. Certain other conditions make the subject of taxation of consumer cooperatives important enough for detailed discus-

sion which will not be attempted in this article.

Accounting for consumer cooperatives is not static. Cooperatives are still in their early stage of development in the United States. They present a definite challenge to accountants. In record keeping, in auditing and internal control procedures, in analysis and interpretation of financial information, in presentation of reports, the accountant for cooperatives has a real opportunity to develop new methods and new ideas.

The New York Certified Public Accountant

THE NEW COOPERATIVE, INC.
EXHIBIT A

Comparative Balance Sheets As of December 31, 1945 and December 31, 1944

ASSETS (What We Have)		
	December 31, 1945	December 31, 1944
CURRENT ASSETS		
Cash on Hand and In Banks.....	XX	XX
Accounts Receivable	XX	XX
Less: Allowance for Bad Debts.....	XX	XX
	<hr/>	<hr/>
Merchandise Inventories	XX	XX
	<hr/>	<hr/>
TOTAL CURRENT ASSETS	XX	XX
INVESTMENTS		
In U. S. Government Securities.....	XX	XX
In Cooperatives	XX	XX
	<hr/>	<hr/>
TOTAL INVESTMENTS	XX	XX
FIXED ASSETS		
Furniture & Fixtures.....	XX	XX
Delivery Equipment	XX	XX
	<hr/>	<hr/>
Less: Allowances for Depreciation.....	XX	XX
	<hr/>	<hr/>
TOTAL FIXED ASSETS	XX	XX
OTHER ASSETS		
Inventories of Supplies.....	XX	XX
Unexpired Insurance	XX	XX
Prepaid Expenses	XX	XX
	<hr/>	<hr/>
TOTAL OTHER ASSETS	XX	XX
	<hr/>	<hr/>
TOTAL ASSETS	XX	XX
	<hr/>	<hr/>
LIABILITIES & MEMBER EQUITIES (What We Owe & What We Own)		
CURRENT LIABILITIES		
Accounts Payable	XX	XX
Accrued Expenses Payable	XX	XX
Federal Income Taxes Payable.....	XX	XX
	<hr/>	<hr/>
TOTAL CURRENT LIABILITIES	XX	XX
OTHER LIABILITIES		
Patronage Refunds Payable.....	XX	XX
Interest Payable on Share Capital.....	XX	XX
Deferred Patronage Refunds.....	XX	XX
	<hr/>	<hr/>
TOTAL OTHER LIABILITIES	XX	XX
MEMBER EQUITIES		
Share Capital	XX	XX
Reserve for Education.....	XX	XX
Patrons' Equity Reserve.....	XX	XX
General Reserve	XX	XX
	<hr/>	<hr/>
TOTAL MEMBER EQUITIES	XX	XX
	<hr/>	<hr/>
TOTAL LIABILITIES & MEMBER EQUITIES	XX	XX
	<hr/>	<hr/>

Accounting for Consumer Cooperatives

THE NEW COOPERATIVE, INC. EXHIBIT B

Comparative Operating Statements for the Years Ended December 31, 1945 and December 31, 1944

	1945	1944	1945 %	1944 %
Sales (at Provisional Prices).....	xx	xx		
Cash Short or Over.....	xx	xx		
NET SALES.....	xx	xx	x	x
COST OF GOODS SOLD.....	xx	xx	x	x
GROSS MARGIN.....	xx	xx	x	x
STORE EXPENSES				
Payroll	xx	xx		
Provision for Vacations.....	xx	xx		
Payroll Taxes.....	xx	xx	x	x
Delivery Payroll.....	xx	xx		
Provision for Vacations.....	xx	xx		
Payroll Taxes.....	xx	xx		
Depn. Delivery Equipment.....	xx	xx		
Other Delivery Expense.....	xx	xx	x	x
Rent	xx	xx		
Heat, Light, Power.....	xx	xx	x	x
Advertising	xx	xx		
Wrapping Supplies.....	xx	xx		
Store Supplies & Expenses.....	xx	xx		
Maintenance	xx	xx		
Insurance	xx	xx		
Taxes & Licenses.....	xx	xx		
Depreciation, Fixtures.....	xx	xx		
Field Service Fees.....	xx	xx		
Professional Fees.....	xx	xx		
Telephone	xx	xx		
Office Expenses.....	xx	xx	x	x
TOTAL STORE EXPENSES...	xx	xx	x	x
STORE OPERATING MARGIN	xx	xx	x	x
OTHER SAVINGS				
Patronage Refunds.....	xx	xx		
Interest on Investments.....	xx	xx	x	x
TOTAL	xx	xx	x	x
OTHER EXPENSES				
Dues to Cooperatives.....	xx	xx		
Education Expense.....	xx	xx		
Interest Expense.....	xx	xx	x	x
NET SAVINGS, BEFORE PATRON- AGE REFUNDS AND FEDERAL INCOME TAXES.....	xx	xx	x	x

A Note on The Mahoney-Mackenzie Law

By THE COMMITTEE ON INSURANCE COMPANIES AND AGENCIES ACCOUNTING

THE bill recently approved by Governor Dewey known as the Mahoney-Mackenzie bill may prove to be a far-reaching piece of legislation. It has uniformity of the accounts of fire and casualty companies as its primary aim, but it may easily spread to other lines of insurance. Furthermore, if it proves to be workable in New York State, and it looks as though it should, it might serve as a model for other states. This is discussed briefly at the end of this paper. As the law is not lengthy, it might well be quoted herewith.

"AN ACT to amend the insurance law, in relation to prescribing uniform classifications of accounts.

"The People of the State of New York, represented in Senate and Assembly, do enact as follows:

"Section 1. Article eight of chapter eight hundred eighty-two of the laws of nineteen hundred thirty-nine, entitled 'An act in relation to insurance corporations, constituting chapter twenty-eight of the consolidated laws,' is hereby amended by adding thereto a new section, to be section one hundred eighty-nine, to read as follows:

"Section 189. Accounts and statistics. The superintendent shall have power, in his discretion, to prescribe by regulation, uniform classifications of accounts to be observed, and statistics to be reported by insurers and other organizations which are subject to the provisions of this article. He may also in his discretion prescribe by regulation, forms of reporting such data by insurers and such other organizations. Such classifications of accounts, and statistics to be reported and forms of reporting shall be reasonable and may vary with the kind or type of insurer or organization. No such regulation or amendment thereto shall be promulgated by the superintendent except

upon notice and after hearing to all insurers and organizations affected thereby. Any regulation or amendment thereto shall be promulgated by the superintendent at least six months before the beginning of the calendar year in which the same shall take effect. Any regulation or order of the superintendent made under this section shall be subject to judicial review by any insurer or organization aggrieved thereby.

"Section 2. This act shall take effect July first, nineteen hundred forty-six.

Approved March 26, 1946."

It will be seen that there are no specific outlines in the law as to just what steps the Superintendent is to follow. Rather the law is a broad one, giving him a considerable amount of discretion. The Insurance Accountants' Association, at a luncheon held April 17, invited Mr. Robert E. Dineen, Insurance Superintendent of New York to be speaker. Those who were not members of the Association and yet were able to attend the meeting were indeed fortunate to be able to hear him, for any fears one might have had as to the manner of enforcement of the law should have been dispelled by Mr. Dineen's talk.

Mr. Dineen opened his address by stating that the manner in which is exercised the power conferred by any law is as important as the power itself. Regulations are yet to be issued, and before these are worked up, there is a vast amount of work to be done by the department, work in which Mr. Dineen hopes for the cooperation of the insurance companies.

The new law does not make any reference to the need for accurate accounts, for the Superintendent had already the power to take appropriate action if the accounts were found not to be accurate, nor does the new law

A Note on the Mahoney-Mackenzie Law

prohibit new classifications. Thus it does not duplicate present legislation, nor does it lay down definitions for use in the future.

Prior to the passage of the bill, the New York Insurance Department had been engaged quietly in the study of present methods of distributing expenses by fire companies. This study of a relatively small number of companies revealed that wide dissimilarities existed between the distributions made by the companies studied, so much so that comparisons could not be made of the accounts as they had been prepared formerly. These studies will be continued, and take in other lines as well as the records of companies outside New York State. For to be of the greatest use to insurance companies, the uniformity of accounting systems, or more particularly, the uniformity of results obtained from the systems, should be national. One can readily see the advantages of knowing that a specific account maintained by a company on the West Coast and also by one on the Atlantic Seaboard contain the same sort of items. To this end the close cooperation of insurance companies and the Superintendent or Commissioner becomes necessary.

Mr. Dineen enumerated several aims of the law as follows:

1. To show that uniform rates are not justified if the expense factors are not uniform.

2. To provide a more scientific basis for the making of rates, and also for the regulation of the rates by the Insurance Department.

3. To aid management by providing the means of more accurate comparison.

4. To provide a more accurate

method, through adequate cost accounting studies, of allocating expenses between different types of risks.

5. To supply data which will justify the charging of different rates.

6. To develop standards which the Federal Government will feel are equal to the standards of industries now regulated by it.

7. To furnish sufficient information to the public so that it can more readily see that the rates charged are reasonable and that by charging these rates the companies are not waxing inordinately wealthy.

The insurance companies were told by Mr. Dineen that the Department has an open mind as to the method of procedure and will welcome constructive suggestions and criticisms. It intends to hold hearings before adopting regulations. It wants to be in the position of being able to demonstrate to any future Congressional Committee that careful studies have been made, that the systems and accounting records have been carefully thought out, that rates being charged are not unfair, whether they are uniform or whether they are different on account of differing circumstances.

Mr. Dineen stressed the need for cooperation between the Commissioners of the several states, mentioning that a Congressional investigating committee would not be satisfied with the procedures of the insurance companies if it found New York State the only one or one of a few states where the procedures were properly covered by legislation and regulations. It would indeed be for the benefit of the insurance companies if the hoped-for cooperation were to materialize.

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Percentage Leases

By DIANA GOLDSTEIN

THE growing popularity of percentage leases has attracted an increasing amount of current legal and accounting thought to some interesting problems connected with their use. The most appealing feature of this type of arrangement, and the one which best explains its present popularity, is its flexibility. Its flexibility is probably best indicated by the fact that its development was initially stimulated by the radically different economic conditions of the depression era. Then, as now, the rather ingenious notion of hitching rental payments to sales volume appeared to be sound business. The idea "clicked" during the depression because such leases enabled landlords to rent stores at low minimum rentals (in days when store vacancies were viewed with something less than gleeful anticipation), while guaranteeing themselves a pro-rata share of the tenants' prospective prosperity without the necessity of waiting for lease expirations. At the same time, merchants could obtain the reasonably long term leases needed to absorb moving and installation costs without saddling infant enterprises with disproportionately high rents.

That the accountant-auditor should quickly find himself embroiled in the complications arising under this type of arrangement is not surprising. Virtually all well drawn percentage leases

call for at least a minimum amount of verification by certified public accountants. The simplest and most practical arrangement is the one which calls for a certification of sales by the tenant's accountants, since this can be conveniently accomplished in connection with the routine audit work. Other leases require a special sales audit by the landlord's accountants and, in extreme cases where, for example, the landlord takes exception to figures furnished him, an examination by auditors representing both the landlord and tenant may be required.

In addition, even before the question of verification arises, the accountant's advice may be required in connection with the original rent calculation. Not infrequently, for instance, the problem arises as to what constitutes "gross receipts," or better yet, "net profit." Careful reading of the lease should disclose whether or not local sales and federal excise taxes, borrowed money, and proceeds from the sale of securities or fixed assets are includible in "gross receipts." And the problems which might arise under a poorly drawn lease in the determination of "net profit" for rent computation purposes may well be left for future discussion.

Often, the auditor first learns that a problem exists when, during the course of an audit, he is made aware of a possible liability (in an undetermined amount) for rents due under percentage agreements. He next discovers that what complicates the determination of the amount (almost invariably) is the failure of the lease year to coincide with the fiscal year.

For example, the M Department Store, Inc.'s fiscal year ended January 31, 1946. Its lease, which is on a calendar year basis, calls for annual rent at the rate of 6% of sales over

MISS DIANA GOLDSTEIN, the author of this article, was graduated from The College of the City of New York with the degree of Bachelor of Business Administration in June, 1943. Since that time she has been associated with the firm of Klein, Hinds & Finke, C.P.A.'s, as staff accountant.

Percentage Leases

\$12,000,000 (plus a monthly minimum, etc.). What liability should be set up at January 31st for rent based on January sales, assuming these to be \$2,000,000, and assuming, further, that the percentage rent for the calendar year 1945 and the monthly rent for January, 1946, were both paid during January, 1946? The amount of the accrual may justifiably be estimated at any one of a number of figures, depending on the circumstances of the case. The one inexcusably wrong answer, however, would be to set up no liability, on the theory that legally no obligation to pay arises until the end of the lease year, and then only with respect to sales, if any, in excess of \$12,000,000. Obviously such an interpretation presents a distorted picture for the purposes of financial statements. The simplest solution is to prorate the \$12,000,000 "quota" over the year, thus allocating \$1,000,000 to each month, and calculating the monthly percentage rent at 6% of the excess sales over the quota.

Of course, this solution is inaccurate in that it fails to take into account seasonal fluctuations; the significance of this inaccuracy, however, is more apparent than real. It should be remembered that the accrual at the beginning of the lease year is a rough estimate, and that over-refinement of method will not necessarily result in increased accuracy. Thus, even if it could be established on the basis of past experience, that January's sales normally represent not 1/12th of the year's total, but perhaps 1/10th or 1/15th, this, in effect, involves an implied forecast of the year's sales. Implicit is the assumption that the distribution of the year's sales will be "normal" and this may well fail to be a better working basis than the premise that it will be pro-rata. The accuracy of the estimate depends primarily on the passage of time, and a year's forecast that is merely hazardous at the end of eight or ten months is meaningless if only one or two months' figures are known.

Incidentally, the error due to seasonal fluctuations is automatically reduced somewhat in the case of chain store organizations having many percentage leases. This is so because each month may represent the beginning of a lease year for several store locations, so that to some extent the heavy sales months included for some stores will offset the light months in others.

Accounting problems also frequently grow out of special lease provisions concerning "fixture rent" and alteration and store-front allowances. Confusion arises in distinguishing between rent and certain other slightly different forms of occupancy expense. If the over-all cost of occupying a given location over the full lease period is viewed in broad outline, it may be understood to include the payments due the landlord under the lease (including minimum, percentage and "fixture" rent) plus expenditures for alterations, partitions, etc., plus possible costs of obtaining the leasehold. Even depreciation of furniture and fixtures may be considered to be an occupancy cost of a retail store in the sense that only a very small percentage of the total cost of equipping the store is represented by movable fixtures, which could profitably be reinstalled at other locations. Furthermore, the salvage value of this portion at the expiration of the lease is negligible. For practical purposes (and depending, as always, on the circumstances of the particular engagement), it may make little difference if certain questionable items are reflected in the expense accounts as rent or depreciation of furniture and fixtures or amortization of leasehold improvements. Certain basic distinctions, however, do exist and should be maintained. The point to be made here is that in the solution of all such problems (no two of which are ever exactly alike), a firm grasp of the realities of the situation must be attained and reflected in the accounting treatment. A few examples follow, illustrating the type of situation referred to.

I

Lease provision: Tenant is to reimburse landlord for furniture and fixtures installed and paid for by the latter in the amount of \$10,000, at the rate of 1% of sales annually.

Query: Are the 1% payments properly chargeable to rent or do they more truly represent capital expenditures, which should be depreciated over the life of the asset?

Solution: If the intent of the parties is merely to reimburse the landlord for the tenant's use of fixtures installed at the landlord's expense, there seems to be no objection to considering these payments as additional rent. If, however, a real sale of furniture is contemplated, with payments deferred, the \$10,000 fixed asset should be set up with a corresponding liability to the landlord, which would be reduced annually by the 1% rental payments. In no event should the annual 1% payments be charged directly to the fixed asset accounts, since the resulting fixed asset figures and varying annual depreciation charges would present a confusing, if not meaningless picture.

II

Lease provision: Landlord is to credit tenant with \$10,000 alteration allowance, against which all percentage rents during the first five years are to be applied. Balance, if any, is to be paid by landlord on given date.

Query: Should the allowance be reflected in the accounts as a reduction of leasehold improvements or should the annual rent expense be reduced by the amount permitted to be applied?

Solution: Inasmuch as the amount expended for alterations actually represents an advance for the account of the landlord, the following entries should be made (1) on the signing of the lease, and (2) annually thereafter for five years, to record percentage rent:

(1) Dr. Due from Landlord and/or Prepaid rent	\$10,000	
Cr. Leasehold Improve- ments		\$10,000
(2) Dr. Rent Expense	xxx	
Cr. Due from Landlord and/or Prepaid Rent		xxx

This solution results in reducing the leasehold improvement account to reflect a more accurate amount, and has the added virtue of 'setting up' the annual rent called for by the lease, which is valuable for comparative purposes.

III

Lease provision: If the percentage rent exceeds \$10,000 in any one year, tenant may apply up to \$3,000 expended during that year to cost of alterations, up to a maximum of \$15,000 over life of lease.

Query: How should the allowance be reflected in the accounts?

Solution: This problem is similar to the one presented above, except that the allowance is contingent upon two factors, i.e., annual percentage rent in excess of \$10,000, and expenditures for alterations. Since the amount and existence of the credit is contingent, it is obvious that it cannot be set up in advance, as it was above.

However, the full amount of the additional rent should be charged annually (as above) to rent expense, and the allowance credited to leasehold improvements. This treatment probably reflects the facts accurately in that the apparent intention of the landlord is not so much to reduce the rent as it is to encourage and share in the expenses of improving the premises.

The impossibility of cataloguing all the problems and pitfalls to be encountered in dealing with percentage leases is obvious. Careful study of the lease provisions combined with consistent application of sound accounting principles should yield a satisfactory solution in each case encountered.

Taxpert's Holiday?

By LEWIS GLUICK, C.P.A.

"I'LL bet you're glad that's over", says the goodnatured dampfool to the taxpert on March sixteenth. The weary taxpert nods assent. He's too tired to speak. "Now you can take it easy", continues the other. The taxpert ignores him—if he can.

For he knows it will be a long time before he can take a vacation; he might, just might, sneak off a half Saturday and a whole Sunday. He's got Federal returns with extensions, lots of State returns due April fifteenth, and more deferred routine audits than his aching head can contemplate.

But along about the end of May, dawn breaks. The taxpert and his partner toss a coin or roll cubes to see who will go away first. And then one of them really does get away; by the fire-escape sometimes, dodging a client who couldn't be persuaded to come in when he should.

Does the taxpert get way from taxes? In the words of Bert Gordon, the not very mad Russian, "Silly Boy!" Of course he might go to courageous Jersey, which has neither sales tax nor income tax; but even in Atlantic City he'd be seeing columns of figures on

the beach, some of them pretty nice, too. But if he seeks to go further, pity him.

Consider some cases.

The Constitution grants Congress sole power to control interstate commerce. However, in recent years, many states have succeeded in interfering with such commerce to a great, and increasing extent. Its principal manifestation is in the control of trucks. This is so intense, and variations in the state rules are so numerous, that the interference with war-time high-priority material movement amounted to a scandal.

The average tourist knows nothing of truck licenses, but runs into other less onerous, but equally annoying, taxes when he crosses state lines. First he has the gasoline or motor-fuel taxes, ranging from a low of two cents in Missouri to a high of seven cents in Florida. These taxes were originally planned to provide funds for highway construction and maintenance, but too frequently are diverted to other purposes. It has been said of several localities that highways have been built through swamps that are impassable on account of mosquitos, and the answer given is, "we haven't got funds for extermination." This taxpert opines that a diversion of even one-half cent a gallon for such a purpose would arouse no resentment and would increase the yield of the tourist crop.

The most frequent source of annoyance is sales taxes. Not all states have them, thank goodness. But some cities have them too. And a tourist is endlessly confused in going from state to state. Some states issue tokens for fractional cents. The tourist always leaves the state with a few, a total loss to him, and in the aggregate a nice profit to the state.

Other states have collection tables,

LEWIS GLUICK, C.P.A., recently returned from active service as a Commander in the U.S.N.R. He has been a member of the Society since 1924. Prior to his Navy career he was engaged in practice on his own account. Mr. Gluick has been an active member, vice-chairman, and chairman of many Society committees. He is also a member of the American Institute of Accountants. He is best known as "The Shoptalker" under which pen-name he has been writing since October, 1928.

whereby the tax commences at a minimum point, say a dime, and then goes up in brackets, so that a difference of one cent in price may add another whole cent of tax. Reputable merchants have these tax tables conspicuously posted by their cash registers. Taxperts look for them, and are not afraid of incurring the cashier's ire by scanning them. Most tourists are traditional sucker-bait.

Accordingly, every tourist should familiarize himself with the rate of tax and manner of collection as soon as he arrives in a state. Auto Clubs would really be a big help if they included such data in their touring information.

Another angle of income tax is only for the man who combines business with pleasure. The angle is particularly acute for a man going from one of those blessed states like Texas, which have no income tax, to one which has. Let's take a simple case. Mr. Stock Dabbler goes from Pittsburgh to California. Pennsylvania has no income tax on individuals; only on corporations. At his resort he finds several stock-brokerage houses. Sometimes it rains in California. He spends those rainy hours watching the board. Mr. Dabbler's habits are strong. He succumbs. He buys and sells on the Los Angeles Stock Exchange and makes money. Joyfully he returns East, leaving behind, with no thought of wrong-doing, unpaid state income taxes on his gains. If he never returns to California, he may escape scot-free. But the taxpert cannot enjoy himself thus. He is so conditioned as to taxes, that, before he even seats himself in the customers' room to watch the Translux ticker readings, he's made careful inquiry of the customer's man, manager,

and cashier, of the tax results of his trading, if he trades. Sure as fate some other customers hear him. His profession is proclaimed. And then—!

Mr. Carefree has gone from Wisconsin to California in January, to spend the whole winter. In California he remembers his federal taxes the beginning of March. The bank which cashes his traveller's checks gives him blanks and even assistance. But the state tax slips his mind. Or if he thinks of it, he says, "Well, I've got to get blanks." Presumptively those blanks were mailed to him at home. Experience shows they are seldom forwarded. If they are, they do not catch up with Mr. Carefree's flitting hither and yon.

State and Federal Income taxes differ in many ways, but in one they are uniform. Failure to receive a blank form is no excuse for delinquent filing. But Mr. Carefree has neglected to have a reliable person (a C.P.A.) forward them to him. So he comes ambling up, beamingly introduces himself, and will Mr. Taxpert please help him out. It's at least an even money bet that Mr. Taxpert does have some of his home state blanks with him. He's had experience.

Back in 1939 he had just such an experience. By wiring his partner to forward some state blanks by airmail special delivery, he picked up a client who became permanent. Clients don't grow on trees. Mr. Taxpert remembers when he packs his bags.

So there ends the vacation.

Verily—Nothing is sure but death and taxes. Some years ago there was a Broadway success titled "Death Takes a Holiday". But taxes never take a holiday. Selah!

Taxation of Businesses Conducted by Charitable Organizations

By GEORGE R. BLODGETT

TAX advisers are regularly harassed by clients who tell of acquaintances said to be growing rich by using tax exempt charities to carry on their businesses. No one can bring about that millenium. But once the client is disabused of the idea that by using a charity he can make money for himself without paying a tax, he can be shown situations where he can help bring to a charity business profits to be retained by it solely for charitable ends, on which it will probably be exempt from federal income taxes, and at the same time he may derive not only mental satisfaction but also personal tangible benefits greater than if no charity had been used but on which he will be fully taxed.

This article discusses the authorities in order to show how slight is the sup-

port for the existing policy of exempting charities on business income; it then considers various types of situations where charities engage in business and the ways in which they are sometimes utilized, the abuses that may crop up and the remedies therefor, and ends with the question of whether the exemption should be continued in the future, and, if not, how the change should be brought about.

The scope of the discussion is the exemption under Code Section 101(6)¹ of organizations pursuing exclusively the purposes enumerated therein if they engage in business enterprises which are not merely incidental to their charitable activities. It relates to such cases as the operation of a manufacturing business by a hospital or a quick turnover of a lot of wool by a university and is not concerned with the college which operates a dormitory and dining hall for students, or the charitable hospital which operates one of its wards as a private ward at a profit, or an institution for the blind which sells chair seats made by the inmates. The word "charity" is used to include all of the permitted purposes detailed in this Section; and, unless the context otherwise requires, it should be understood that each organization has only these purposes (no attempt being made in this article to discuss their scope), that the ultimate or "end" use of all the income of the business activities will be solely for the furtherance of these charitable objects, that every transaction is

GEORGE REDDINGTON BLODGETT is a partner in a prominent law firm in Boston, Massachusetts. He is a graduate of Yale and received his legal education at Harvard University. He is a member of the American, Massachusetts and Boston Bar Associations and has written articles on tax subjects for various magazines.

This article is a condensed version of a paper read by Mr. Blodgett before the Fourth Annual Institute on Federal Taxation at New York University and which was printed in full in the published Proceedings of the Institute.

¹ "The following organizations shall be exempt from taxation under this Chapter—

"... (6) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation;"

real and on fair terms, and that the organizations discussed have not violated any of the specific prohibitions of Section 101(6).²

The Authorities

The legal problem is whether a charity which engages in business activities not merely incidental to its charitable purposes, although solely to obtain funds which will be applied ultimately only to these purposes, is "organized and operated exclusively" for the permitted charitable ends within the meaning of Section 101(6).³ The present practice of the Bureau of Internal Revenue, which has continued for a period of many years, is not to deny exemption in such situations. This practice is supported by such published rulings and decisions as exist, but they are too few to satisfy the practitioner⁴ who finds it impossible to feel any definite assurance that the present practice will not be changed retroactively by further judicial construction or prospectively by legislation, despite the unwillingness of Congress to date to make, or apparently to consider seriously, any statutory change.

The wording of the exempting clause of the Statute has not been changed since original enactment in 1909 in any respect material to this problem.

² Reference in this article to business activities conducted by charities do not include the incidents of normal investment activities, such as the receipt of dividends, bond interest, and mortgage interest resulting from investment of the endowment. The receipt of rental income by charities is not specifically considered.

³ Any attack would presumably be by denying exemption under Section 101(6) to the organization, which would logically involve imposing a tax on all of its net income and not merely on the part derived from business activities not directly incidental to charitable purposes, except in the case of trusts able to take advantage of Section 162(a).

⁴ No attempt is made to consider comprehensively the problem of the exemption from income tax of a corporation, organized under the business corporation law solely for the purpose of the active conduct of a business, by reason of the fact that all of its capital stock may be owned by an exempt charity. This kind of situation must be differentiated from cases where a corporation, organized under the general business law, engages in business activities for a profit but itself applies those profits directly to the charitable purposes for which it is primarily organized and operated. (*Sand Springs Home*, 6 BTA 198 Acq.) The leading case on "feeder" corporations is *Roche's Beach, Inc. v. Commissioner*, 96 Fed. (2d) 776, CCA 2, where exemption under Section 101(6) was allowed a business corporation conducting only business activities (operation of a bathing beach of 3,000 bath houses and prosecuting a condemnation claim) because the earnings would be used ultimately for activities of a charitable corporation which owned all the stock.

⁵ *Trinidad v. Sagrada Orden de Predicadores*, 263 U. S. 578.

The leading decision dealing with charities in business is the *Sagrada*⁵ case in the United States Supreme Court in 1924, which, except as to rents, is limited by both its facts and language to business activities which were purely incidental to its religious purposes. The religious order there involved had large holdings of real estate from which it received very substantial rents, income from securities and loans, and profits from the sale of wine, chocolate and other articles used in its own organization which profits amounted to less than 3% of the total income and to only about \$3,000. In holding that the exemption was not lost because of either the rents or profits, the Supreme Court said:

"According to the Philippine law under which it is created, all of its properties are held for religious, charitable and educational purposes; and according to the facts stipulated it devotes and applies to those purposes all the income—rents, dividends and interest—from such properties. In using the properties to produce the income, it therefore is adhering to and advancing those purposes, and not stepping aside from them or engaging in a business pursuit.

"As respects the transactions in

Taxation of Businesses Conducted by Charitable Organizations

wine, chocolate and other articles, we think they do not amount to engaging in trade in any proper sense of the term. It is not claimed that there is any selling to the public or in competition with others. The articles are merely bought and supplied for use within the plaintiff's own organization and agencies,—some of them for strictly religious use and the others for uses which are purely incidental to the work which the plaintiff is carrying on. That the transactions yield some profit is in the circumstances a negligible factor. Financial gain is not the end to which they are directed.

The Court also said:

"Two matters apparent on the face of the clause go far towards settling its meaning. First, it recognizes that a corporation may be organized and operated exclusively for religious, charitable, scientific or educational purposes, and yet have a net income. Next, it says nothing about the source of the income, but makes the destination the ultimate test of exemption.

"Evidently the exemption is made in recognition of the benefit which the public derives from corporate activities of the class named, and is intended to aid them when not conducted for private gain. Such activities cannot be carried on without money; and it is common knowledge that they are largely carried on with income received from properties dedicated to their pursuit. This is particularly true of many charitable, scientific and educational corpora-

tions and is measurably true of some religious corporations. Making such properties productive to the end that the income may be thus used does not alter or enlarge the purposes for which the corporation is created and conducted * * *

" * * * In using the properties to produce the income it therefore is adhering to and advancing those purposes, and not stepping aside from them or engaging in a business pursuit."

Note that the Court justified the rents on the mere ground that the end use was charitable, and found no necessity to limit this broad position by describing the rents. It appears only that they were from very "large properties" and constituted over one-third of the gross income. On the other hand, justification for disregarding profits from the sales is predicated on the facts that they were merely incidental to the charitable purposes, were not dealt in for financial gain, and did not constitute engaging in trade or involve selling to the public or in competition with others. This decision furnishes little support for contending that charities do not lose their exemption by engaging in business activities not incidental to their charitable purposes, except in the case of rents.

Sand Springs Home, 6 B.T.A. 198 (1927), is a clear-cut decision upholding the broad exemption, and it is significant that this case has been acquiesced in by the Bureau.⁶ The organization actively conducted extensive charitable operations,⁷ owned and operated a

⁶ Acquiesced VI-1 CB 5.

⁷ The petitioner in *Sand Springs Home*, 6 BTA 198 (Acq.), actively conducted charitable operations formerly carried on by an individual, but had business activities of such extent that the amount of deficiency and tax asserted was \$232,868.60 at 1922 rates.

Petitioner was organized for stated charitable purposes and for the express purpose of obtaining income with which to carry out those purposes, and it was authorized by its incorporation papers to engage in a large variety of different business activities. The incorporation papers expressly reserved to the individual who had originated the charitable activities the sole right to direct the corporation in all respects during his life, although he was only one of five trustees. The decision apparently considered immaterial what part of the net income was expended for charitable purposes and what part was retained, since the findings of fact expressly state that that was not shown. In *Sand Springs Railway Co.*, 21 BTA 1291, it was held that a power, light, and water company, and a gas company, all of the stock of which was owned by Sand Springs Home were not exempt from taxation.

cotton gin, oil and gas leases, sold oil and gas, generated electricity maintained reservoirs selling water to the public, and owned an amusement park which it had leased. These activities were not merely incidental to its charitable purposes, but involved dealing with the general public and competing with similar businesses. The Board said in part:

"The respondent admits that the petitioner is a charitable institution but contends that it is not operated exclusively for charitable purposes, since it owns and operates a number of business enterprises which produce income more than sufficient for carrying out its charitable activities and which are in direct competition with individuals and nonelectrosynary corporations. This contention presents no difficulties here. It is true that the petitioner owns a large amount of property and a number of business enterprises which are producing and in the past have produced income in excess of the amounts required to maintain the Home and other charitable activities in which the petitioner is engaged ***.

"However, the fact that the petitioner owns property which produces income in excess of its immediate needs does not alter or change its character or make it any the less a corporation organized and operated for charitable purposes. If any organization designed and established to dispense charity on a large scale is to be effective, it can not itself be entirely and continually dependent on the charitable whims of individuals and be compelled to seek funds for its activities by constant appeals to those persons of means who may be charitably inclined. It is proper that these organized charities should have large

permanent endowments in order to provide revenue sufficient to supply the immediate needs of their charitable activities and to enable them to enlarge and expand those activities as occasion may require. This petitioner is in a fortunate position among corporations of its kind. It has happened that the property turned over to it by its founder has proved to be extremely valuable and has produced income not only sufficient to take care of the immediate needs of its charitable enterprises but also to increase its permanent endowment. This income not only enables it to dispense charity on a large scale but makes it potentially a dispenser of charity on a still larger scale as the objects of its bounty may increase in number. In this way it serves and can continue to serve the public by caring for destitute and infirm persons who might otherwise become public charges."⁸

This decision is the main support of the present practice.

The case of Roche's Beach, Inc.⁹ supports this position by necessary implication. The question was whether a business corporation organized merely to take title to and operate a bathing beach business, with gross income of about \$100,000 a year and net income of \$23,000, was exempt under Section 101(6) solely because all of its dividends would go to its sole stockholder, an active charity. The holding of the Circuit Court of Appeals for the Second Circuit that the business corporation was exempt because the end use of the income would be for the permitted charitable purposes necessarily implies that the charity would have been exempt if it had owned and operated the bathing beach directly instead of through the business corporation.

⁸ The Board said, "In the case of *Trinidad v. Sagrada Orden de Predicadores*, 263 U. S. 578, the Supreme Court of the United States had before it a situation which is practically identical with the situation involved herein." A valid distinction between the two cases can be based upon the volume of the business activities and the extent to which they were purely incidental to the charitable activities.

⁹ 96 Fed. (2d) 776, CCA 2.

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There are no decisions or rulings denying exemption because the charity itself engages in business. Many decisions support the exemption where the business activity was purely incidental to the charitable activity.¹⁰ Charities engaging extensively in business have been held exempt under other federal tax laws worded similarly to the income tax exemption.¹¹ Decisions under the provisions of Section 101 granting exemption to organizations other than charities have some bearing on the matter and they tend in general to permit incidental profits.¹²

The asserted public policy to exempt charities from taxation has been emphasized in many decisions on the grounds

¹⁰ *The Goldsby King Memorial Hospital, a corporation*, TC Memo Opinion, July 19, 1944; *Appeal of Unity School of Christianity*, 4 BTA 61 (Acq. VI-1 CB 6); *Commissioner v. Battle Creek, Inc.*, 126 Fed. (2d) 405, CCA 5, March 17, 1942, affirming BTA Memo Opinion; *United States Lawn Tennis Association*, TC Memo Opinion, August 11, 1942; *Davis Hospital, Inc.*, TC Memo Opinion March 14, 1945; *American Society of Cinematographers, Inc.*, 42 BTA 675.

¹¹ *Bohemian Gymnastic Association Sokol of City of New York v. Higgins*, 147 Fed. (2d) 774, CCA 2, March 8, 1945; *Linderman v. Driscoll*, 26 Fed. Supp. 565.

¹² *Town and Country Club*, TC Memo Opinion December 30, 1942; *Savings Feature of the Relief Dept. of the Baltimore & Ohio R.R. Co.*, 32 BTA 295 (Acq. XIV-1 CB 18); *Crooks v. Kansas City Hay Dealers' Ass'n*, 37 Fed. (2d) 83; *Eugene Fruit Growers Ass'n*, 37 BTA 993; *Forest Lawn Memorial Park Ass'n, Inc.*, 45 BTA 1091 (nonacq. 1942-1 CB 23); *Santee Club v. White*, 87 Fed. (2d) 5.

¹³ *Harrison v. Barker Amnity Fund*, 90 Fed. (2d) 286, CCA 7 (1937); *Bohemian Gymnastic Association Sokol of City of New York v. Higgins*, 147 Fed. (2d) 774, CCA 2, March 8, 1945; *U. S. v. Proprietors of Social Law Library*, 102 Fed. (2d) 481 (CCA 1) no cert.; *Roche's Beach, Inc.*, 96 Fed. (2d) 776; *G. C. Mn. 21610*, CB 1939-2, p. 103; *Merten's Law of Federal Income Taxation*, Vol. 6, Sec. 34.02.

¹⁴ It seems that the statutory requirement of "organized . . . exclusively" for the permitted purposes should be considered to be met whenever a corporation's charter and related documents are amended so as to bring it within this requirement, even though it was originally incorporated for business or other purposes. The important requirement, from the standpoint of protecting tax revenues, is that future income which is to be exempt from tax should never be available for any end use that is not charitable, and this test is met wherever the corporation is legally prevented, under the laws of the state of incorporation, from applying the funds for any other purpose, irrespective of the purposes for which it was formerly incorporated or operated. In *G. C. M. 21610*, CB 1939-2, p. 103, the view was expressed that:

" . . . as a general rule, the purpose of an organization should be determined from the instrument creating it. However, this rule is subject to the exception that where (as in *Roche's Beach*) the net income of an organization is required by some other binding instrument to be used for charitable purposes, its exemption will not be defeated by the fact that its charter or other instrument under which it exists does not indicate an exclusively charitable purpose. . . . This exception to the general rule should not be extended to cases in which there is no such binding instrument requiring that the income be devoted to charity, even though the income is in fact devoted to charity. The exception to the general rule is also confined to cases in which (as in *Roche's Beach*) the intent which prompted the original organization was an intent to set up an organization to be operated exclusively for charitable purposes."

This ruling was later modified, insofar as it lent approval to the *Roche's Beach* decision, but is otherwise unrevoked. To insist that the organization must have met the requirements of Section 101(6) from the date of original incorporation would impose hardships in many cases, often those of the oldest and most reputable charities, and might force some of them to the expensive but otherwise inconsequential step of organizing a new charitable corporation, pure in these respects from its inception, and transferring all of its real estate and securities and charitable activities thereto.

given in the foregoing quotations from the *Sagrada* case. The exemption is construed more liberally in the case of charities than in the case of other organizations described in Section 101.¹³

The Regulations are not helpful. They are unchanged since 1920 in important respects except for a change made in 1925 in the Regulations under the 1924 Act to allow exemption in the type of situation involved in the *Sagrada* case, *supra*, which was denied exemption under the former Regulations.

The decisions give no clear interpretation of the requirement that the entity be organized for charitable purposes.¹⁴

Instances of Charities in Business

Business activities conducted by charities fall into one of two classes: the routine conduct of an ordinary business enterprise such as manufacturing or merchandising; or transactions, often of a non-recurring nature, which may be

The first class needs no explanation, referred to as "deals."

A daily newspaper of wide-circulation and very high standing, devoted almost entirely to general news and advertising, has for many years been published by the Christian Science Church in both Boston and the Pacific coast. It is exempt from income tax. The Mormon Church may own and operate, tax exempt, many of the public utilities and business enterprises in Utah. It is often possible for a charity to offer better terms for a business than a taxable entity can afford, because the charity can pay the purchase price more rapidly out of future earnings which will not be reduced by taxes, or, if it makes a cash payment out of its endowment, can recoup that investment from earnings more rapidly than would be possible for any private operator. So long as charities enjoy exemption from income tax on income from investment securities, it is difficult to find any clear-cut reason to tax them on income in these situations, unless the practice should grow so great as to result in excessive losses of tax revenues or competition of an unfair nature with private business or undue concentration of economic power or unless wide abuses develop which cannot be curbed by other means.

The transactions which may be characterized by the word "deal" usually involve some advantage or benefit to an ordinary taxpayer as well as to a charity. Cases of this type are often subject to hasty criticism which usually disappears on careful analysis. Courts should have no hesitation in imposing a tax where any party other than the charity is favored by unduly low selling prices, rents, options to repurchase, etc.,

although in these cases the appropriate remedy will often be to deny the tax benefit to the ordinary taxpayer rather than to deny the exemption of the charity.

One large class of cases is where advantage is taken of the fact that the charity can accumulate cash resources from a given business enterprise faster than a private individual, since it pays no income tax. Another class of case is the very prevalent one where a taxpayer owning a plant or equipment sells it for a tax loss. If a charity is the buyer at an outright sale for a fair price, and later makes a profit by operating the property or selling it to an independent third party, its tax exemption should not be affected merely because someone else sought to reduce taxes in a way expressly provided in the tax law. Any attack should normally be made upon the allowance to the seller of the loss on the sale. The question of whether in such a case the seller should have a tax loss is outside the scope of this article, although if he is to be allowed such a loss on a bona fide sale to an independent taxpaying entity, there is no reason why he should be denied his loss (or the charity its exemption) because the sale is at the same, or perhaps a higher price, to a charity. The charity is in a position to pay as much or more than anyone else through its ability to operate or lease the property tax free, and if it pays a high price, the tax loss to the seller is reduced. If the sale is at an unduly low price, the seller has in effect made a gift to the charity which jeopardizes the seller's tax deduction but should not affect the exemption of the charity. Sometimes such sales are accompanied by leases or options back to the seller. If the rent or option price is fair and the transaction is one calculated to show the charity a reasonable profit, the charity should not lose its exemption because of engaging in a transaction which might have been undertaken by a taxpaying entity. It is possible to imagine a case of this type so extreme that a court could find that a

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principal purpose of the organization or operation of the charity was to benefit the seller through this transaction, in which case the charity should properly lose its exemption, but a court would probably reach such a drastic result with less difficulty in the case of a charity recently organized or controlled by interests affiliated with the seller than in the case of a long-established reputable charity where only a small portion of its funds are involved.

A third class of case is where a charity is utilized because it can withdraw money from a business corporation in which it owns stock without taxes, whereas an ordinary stockholder cannot do so. This is often done to facilitate payment of a purchase price. An individual may see an opportunity to buy advantageously all of the stock of a manufacturing corporation where the stockholders wish to sell out for a fixed price payable promptly in cash. The individual is interested in acquiring only a part of its properties. If he borrows to buy the stock, he is faced with almost insuperable tax difficulties in withdrawing money from the corporation with which to pay his individual loan, unless he is willing to liquidate the corporation in which case he may encounter tax difficulties in valuing plant assets and goodwill which he receives and further tax problems if he reincorporates some or all of the assets. His situation is not much better if he does not have to borrow to buy the stock, because even then he will have used his individual cash resources and he will be faced with the same tax problems in recouping his individual cash position from the corporation's assets. The alternate plan is for a charity to borrow the money and buy the stock, and it may then without tax withdraw from the corporation in the form of dividends excess cash reserves or proceeds of sale of plant and apply them to reduce its own borrowing. The individual may buy or rent from the corporation such plants as the charity will cause the corporation to sell or

lease to him, provided that the prices are fair. In the end, the charity should be left with a profit in the form of cash or stock of a corporation stripped of some of its quick and/or plant assets, and the individual will have acquired or leased the plants he desired but only at a fair price.

Another class relates to situations where an individual promotes business deals on behalf of a charity for no other reason than the mental satisfactions of making a tax-exempt profit and of building up a charity. He may wish to establish in his community a bona fide charitable tuberculosis hospital, and be willing to contribute to that end his ability but not his own funds. He organizes a charitable corporation for these purposes, and causes it to engage, as principal, in deals which he originates and directs. Since it has no assets whatever at the start, he enables it to borrow the necessary funds from banks by giving his personal guarantee of repayment. He devotes only time and ability to any particular deal, taking no personal participation in it. No hospital can be built or operated until the charity accumulates the necessary funds in this manner, but in the meantime its assets are so restricted that they cannot be used for any private purpose and, subject to the right, to use them in future deals for the same end purpose, the assets of the corporation must ultimately be used for these charitable purposes or related ones under the *cy pres* doctrine. He, his family and associates take no compensation or other remuneration directly or indirectly from the charity except reimbursement for out-of-pocket expenses. The benefits to him are largely mental satisfactions of kinds which generate most gifts to charity, although they may extend to having the charity named after him or to taking an important part in its affairs. There is no precedent or reason to tax the income to him in such situations, much less for denying the exemption to the charity. The current tendency of course to consider "mental

satisfactions," and powers of management or control which fall short of ability to change the ultimate beneficiary, as a basis for imposing an income tax in certain situations of private trusts should not extend to income irrevocably dedicated to a charitable end use.

The final result of these situations is that exemption from income tax is given only on profits which are irrevocably dedicated to a charitable end use, and that the other parties to the transaction pay their ordinary taxes on all tangible benefits they receive. If the use of the charity facilitates increasing an individual's income, the tax revenues are similarly increased. The private party may also derive mental satisfactions from benefiting the charity through the use of his ability, but that affords no basis for increasing his taxes when the long-established policy of the tax law is to afford him a deduction from taxable income when the same mental satisfactions lead him to make a gift to charity. The individual may also derive in this way a power to control substantial business enterprises through his voice in the charity.¹⁵ If that control is exercised solely for the benefit of the charity, it amounts to only a mental satisfaction to him; if it is exercised for his pecuniary benefit or that of his associates, taxes will properly be levied on them and the charity may be denied exemption; and if it is abused for purposes contrary to

the public interest, there are probably other laws to correct the abuse but in any event correction is not the function of the Internal Revenue Code.

Remedies For Abuses

Continuance of the general principle of exempting charities engaging in business would not deprive the courts of remedies for abuses. A charity which pays excessive compensation to its trustees or founders properly loses its exemption because it is not organized and operated exclusively for charitable purposes.¹⁶ The loss on a sale by a business corporation of its plant to a charity at a lower price than could be obtained elsewhere for the purposes of registering a tax loss, may properly be disallowed as essentially a gift rather than a sale; payment of an unduly high rent under a lease may be disallowed for similar reasons and, if it is coupled with an option to repurchase the property at an unduly low price, may be a capital payment rather than rent, in addition to the danger which inheres in the frequently overlooked and largely unconstrued provision of section 23(a) implying that rent is not deductible on property to which the taxpayer is taking title or in which he has an equity.¹⁷ All these abuses can exist where the purchaser is a taxable entity. There is no reason for penalizing the purchaser except in those cases which are so extreme that it can fairly be said that one of the substantial pur-

¹⁵In the *Sand Springs Home* case (see note 9 above) the founder retained complete control in his own hands during life as one of the trustees, to the exclusion of the other trustees. In *U. S. v. Proprietors of Social Law Library*, 102 Fed. (2d) 481, where an educational institution maintained a large law library used by members of the bar who paid dues, exemption was not denied because the beneficiaries were largely dues-paying subscribers and "proprietors" who shared in the same benefits.

¹⁶*Northern Illinois College of Optometry*, TC Memo Opinion August 23, 1943 (The close parallel of salaries and profits, along with other factors indicated that payments were not based upon services performed but "represented a means and practice of distributing petitioner's net earnings under the guise of salary.") See, however, for cases in which exemption was allowed, *Sands Springs Home*, 6 BTA 198 (Acq.). *Forest Lawn Memorial Park Association, Inc.*, 45 BTA 1091 (Nonacq.); *Comm. v. Battle Creek, Inc.*, 126 Fed. (2d) 405, CCA 5, March 17, 1942; *The Goldsby King Memorial Hospital*, TC Memo Opinion, July 19, 1944.

¹⁷"In computing net income there shall be allowed as deductions: . . . rentals . . . of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

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poses for which the charity was organized or operated was to benefit the seller, when the exemption should be disallowed under the express statutory prohibitions against operation for other than charitable purposes or for the benefit of any private individual. Secret understandings, undisclosed benefits, "unreal" transactions and the use of fictitious prices or rents are matters for which the tax courts have found the proper solution when they arise in transactions between ordinary taxpayers. If situations of this type arise which involve alleged charities they can be handled in the same way by the courts without destroying the present exemption of charities generally from income tax.

As an aid to ferreting out abuses, charities and other organizations claiming exemption might properly be required to file annual financial information as complete as the tax return of an ordinary business corporation, and such other information as the Commissioner might require. Exemptions previously granted should be regularly reviewed by the Bureau of Internal Revenue.

Future Legislative Policy

Turning to the question of what the law should be in the future, we start from the practice which has existed many years of exempting charities from income tax pursuant to an asserted public interest in furthering their activities, and, as actually applied, of embracing in that exemption income

of all kinds, including that from business activities, so long as the end use is charitable. These institutions, perhaps educational institutions in particular, have already suffered a large decrease in their current rate of return on investments, ordinarily have substantially increased operating expenses, and are faced with the probability of a decrease in large gifts and endowments because of the difficulties which present tax rates place in the way of accumulating the large private fortunes from which most of these gifts have come in the past. From the point of view of the charity, the need for exemptions seems at least as great now as ever.

The principal arguments against exempting charities from income tax on business income alone relate to (a) loss of tax revenues, (b) improper competition with private business, and (c) undue concentration of economic power if the tax exemption permits charities to acquire and hold control of many business enterprises.¹⁸ These are all matters of degree. There is no evidence that the extent of business activities of charities at the present time, or in the near future, will be so great as to make these dangers sufficiently substantial to require a change of tax policy at this time. The large accumulations of property held by religious organizations in past centuries in many Latin countries shows that there are inherent possibilities of dangers of this kind, but present public acquiescence in the other broad exemptions of charities from taxation shows that this

¹⁸ If widespread abuses existed, which were not curbed by administrative or judicial procedures, within established precedents, they might afford an additional argument for removing the exemption. The reported decisions involve few cases indicating abuse, and the courts have denied exemption on grounds which seem proper, principally that the organization was so employed that the profits inured to the benefit of private shareholders or individuals. (*Northern Illinois College of Optometry*, TC Memo Opinion August 23, 1943. Petitioner was denied exemption under Section 101(6), on a finding that earnings of the corporation were distributed as salaries.) Evidence that the Bureau of Internal Revenue has found little abuse is indicated by the absence of petitions on this subject pending in the Tax Court at the present time, and by the fact that when the Treasury Department recommended to Congress in 1942 that the exemption of charities be terminated as regards business activities, the recommendation was based on the element of competition with private business and no reference was made to abuses.

danger is still remote.¹⁹ The figures released in the report of the Staff of the Joint Committee on Internal Revenue Taxation regarding tax exempt organizations show a compilation of total business gross receipts of charities, taken from the Forms 990 for 1943, which are probably misleading and certainly do not indicate the volume or net income of non-incidental businesses. The form calls for "gross receipts from business activities (state nature)" but does not call for a subdivision of disbursements into business and non-business salaries and other expenses, with the result that it is impossible to determine from the forms the net income from business enterprises. It is probable that a large part of the gross receipts there reported are from business activities which are directly incidental to the primary charitable purposes. The additional tax revenues that could be derived from taxing these sources would not be large, particularly as many charities would leave this field promptly and invest their funds in bonds and mortgages which would presumably continue tax exempt. The loss of tax revenue is no greater if the charities receive the dollars which they are to spend from business income than if the same number of dollars comes from interest or rents which have always been held tax exempt for reasons of public policy.²⁰ Receipt by charities of funds as contributions involves an income tax deduction to the contributor, which adversely affects the tax revenues and which has no counterpart when the charity earns business income. As regards improper com-

petition with private business, it is hard to find evidence of adverse effects on the economy because of the income tax exemption of charities. The exemption benefits the charity only if it operates the business profitably, and unfair competition is usually associated with operating at a loss rather than at a profit. Conceivably, continued active conduct of business by charities might embrace such a large part of a single industry that, through greater ability to accumulate reserves to weather bad times or otherwise, charities might have a real advantage over private business, but the writer knows of only one industry of which charities now own a large part. The general tendency would be for them to spend their business income rather than to accumulate it. The large holdings by charities of income-producing real estate in New York and other large cities probably have no serious adverse effects on private owners merely because the charities enjoy an exemption from income tax. These possible objections to the continuation of the tax exemption of businesses conducted by charities all come down to questions of degree. The volume is probably far from the point where a change in policy is needed, and if that point is ever reached the change can then be made quickly and decisively by Congress.

One practical difficulty of attempting to tax charities on only the income of non-incidental trades or businesses is the difficulty of determining what constitutes an investment activity as distinguished from an independent trade or business. How can a statutory line be drawn satisfactorily dif-

¹⁹ Several states have statutes restricting the amount of property which may be held by a charitable corporation unless specific legislative approval is obtained.

²⁰ "If petitioner has been fortunate enough to discover a means whereby its exempt activities can be made to finance themselves, the public, which would otherwise be called upon to contribute support, is the gainer. And Congress cannot be assumed to have legislated on a contrary principle." *U. S. Lawn Tennis Association*, BTA Memo Opinion, August 11, 1942; "This petitioner is in a fortunate position among corporations of its kind. It has happened that the property turned over to it by its founder has proved to be extremely valuable and has produced income not only sufficient to take care of the immediate needs of its charitable enterprises but also to increase its permanent endowment." *Sands Spring Home*, 6 BTA 198 (Acq.)

ferentiating between a church's cookie sale or children's play and the active conduct of a business such as a cotton gin or production of the servicemen's play "This Is the Army"? While holding title to real estate acquired by bequest and subject to a long-term lease might well be considered an investment activity, and operation of a large metropolitan office building would constitute a business, between these two extremes are innumerable gradations, involving such problems as income-producing real estate acquired in necessary foreclosure of investment mortgages, real estate bought in the open market (perhaps subject to mortgages) as distinguished from real estate acquired by gift or bequest, and the rebuilding at large expense of obsolete properties. At what point do frequent changes of investments due to more than ordinary careful following of investment trends and market prices pass over the borderline that separates keen investment from speculation? Legislation cannot be framed which lays down with reasonable definiteness a distinction between investment activities and engaging in a trade or business, and charities should not be left in uncertainty on points which would become so vital to their tax exemption. The public policy which is asserted to justify exempting charities from taxation should protect them against the inherent uncertainties of administrative and judicial interpretation of a necessarily vague statutory line of demarcation.

If the exemption of business income which charities now enjoy in practice is ever to be taken away from them, either now or later, the change should be made by legislation and not by court decisions. The considerations which would lead to such a change, namely excessive loss of tax revenues, unfair competition with private businesses, undue concentration of economic power, and excessive abuses, are matters of degree and questions of general public policy to be passed upon by

Congress after hearing all of the facts and all interested parties. Changes of long established practice made for such reason should not be within the province of a single judge, or a court of several judges, after hearing only the parties to a single case. Hard cases make bad law, and the great number of bona fide reputable charities should be spared the danger of having their tax exempt status changed, or even clouded, by a court decision rendered on a point of small importance to the total revenues but of overwhelming importance in the social field. Such a decision would produce unutterable confusion if, by throwing doubt on the exemption of income of a charity from independent business ventures, it forced an immediate change in the investment policies of universities and hospitals, or if its logical extension involved any possibility of loss of exemption because a college leased out a meeting hall built primarily for students or a hospital operated the X-ray department at a profit or the French Relief conducted a restaurant. The wording of Section 101(6) is such that a charity receiving income from any source outside the scope of the Section would apparently lose its exempt status and be required to include in gross income all of its income from every source, a result so serious that once the slightest doubt is raised that a charity might be taxable on any income, all charities would tend to withdraw from every field of investment which could be brought by subsequent court decisions within that principle. There would also be extreme hardship if the settlor-trustee of a bona fide charitable trust had all of the charity's income included in his surtax brackets by the Bureau and was left without right to be reimbursed for the tax thereon from the funds of the trust. Congress is the proper body to consider such broad questions of policy, not the courts. Changes in the law by Congress are usually prospective only, while any decision of a court necessarily has retro-

active effect. If there is any public policy to further the financial affairs of charities, they should be protected from retroactive changes of this nature, and from such great confusion and uncertainty, continuing over long periods of years, as those which have resulted from judicial attempts to change long continued practice in such tax matters as the definition of "reorganization" and the taxation of situations within the principle of the current Clifford²¹ and Stinson²² cases. We have had a statute and regulations on this subject unchanged in essential

respects for thirty-six years, and an administrative practice of very long standing. Any needed changes should be made by Congress. Its attitude is shown by its flat rejection of the Treasury Department's recommendation in 1942 to tax charities on business income. Change should not be within the province of any court. Unfortunately, one of the few forecasts which can be made in this field with reasonable certainty is that if any fundamental change is actually made in the foreseeable future, it will be made by the courts and not by Congress.

²¹ *Helvering v. George B. Clifford, Jr.*, 309 U. S. 331 (1940).

²² *Fidelity-Philadelphia Trust Co. et al, Exrs. (Stinson Estate) v. Rothensies*, 142 Fed. (2d) 838, CCA 3 (1944).

The "Lifo" Method of Inventory Valuation in Income Taxation

Whether merchandisers may use a price index in valuing inventory under the last-in-first-out (Lifo) accounting method is being tested in the U. S. Tax Court.

The "elective method" of pricing inventory, as "Lifo" is called in the law, was legalized for tax purposes nearly a decade ago. Its purpose is to iron out the hills and valleys in earnings in some industries due to fluctuations in the prices of commodities entering into the inventory. When the system is used, inventory last purchased is considered as first sold. Book inventory is thus practically frozen at a "base price" obtaining when the system was put into effect. As a result, earnings in years of ascending prices for goods are not greatly inflated by rising prices. Similarly, declining commodity prices have little effect on profits.

Earnings of merchandisers are severely affected by fluctuations in the prices of goods. In the price decline that occurred in 1920-21, after the first World War, many of them took enormous inventory losses and there were numerous bankruptcies and reorganizations. Because of this, retailers were anxious to employ "Lifo" to level out their profits and losses. The snag is that the use of "Lifo" contemplates the replacement of goods sold with essentially similar goods, and merchandisers' inventories, largely because of the style factor, usually change materially from year to year. To overcome this difficulty many retailers adopted the use of a commodity price index to adjust the market value of inventories at the end of each year to the theoretical base price. The Treasury, however, has consistently refused to accept this idea.

The test is being made in the case of Hutzler Bros. & Co., of Baltimore. A Tax Court decision is expected late in the year. Whatever the decision an appeal to the higher courts seems certain.

THE WALL STREET JOURNAL
"Tax Report",—June 12, 1946.

Two Tax Systems

(A Reply)

By CURT GRUNEBERG

MORE and more, accountants are becoming aware of the advantages which may be derived from a knowledge of a foreign tax system, particularly of the British system of income taxation. Therefore, the recent publication of Mr. George Lieberman's article dealing with differences between British and American income taxes deserves special appreciation. However, the article could not possibly encompass a complete review of these differences and was not intended to do so. For this reason some points may be added, not only because of their theoretical and practical importance, but also because of their special appeal to accountants.

I

Differences in Accounting Methods

It is rather surprising that Mr. Lieberman's article, as well as all other discussions on British income taxes in American professional books or magazines (as far as they are known to this

writer), completely omit the accountant's viewpoint, a matter of the greatest importance in every income tax system. In this respect the differences in accounting methods are well worth mentioning.

The accounting methods are fundamentally the same in this country and in Great Britain. In the famous case *Dailuaine-Talisker Distillers, Ltd. v. C.I.R.* (1930), Lord Justice Clyde stated:

"... it is elementary that a profit and loss account is not an account of receipts and expenditures in cash only. . . . The profits arising or accruing from a business which are assessable to income-tax are none other than those which are ascertained on ordinary principles of commercial trading by a sound system of commercial bookkeeping. . . ."
This is an acknowledgment of

- a) the two accounting bases, cash basis and accrual basis, and
- b) the principles of "good accounting practice".

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Mr. Grunberg has written two books and many articles dealing with accounting and tax problems, two of which have recently appeared in *TAXES* (The Tax Magazine). He is presently connected with a New York firm of Certified Public Accountants.

However, this recognition of common general principles exists only in theory. The practice yields a decidedly different result. Whereas in this country every taxpayer may select a standard method of accounting which suits him best as long as it clearly reflects his income (I.R.C., Sec. 41.), the accounting method in Great Britain depends to a large degree on the source of income classified according to the "Famous Five Schedules", which divide all kinds of income according to their sources. They not only have a technical meaning but they also have great influence on pertinent tax questions.

1) *Schedule A: Income from the Ownership of Land and Buildings*

The tax on income from real property in Great Britain is completely different from our income taxation on real estate. In this connection, attention may be directed to the fact that, because of a different income concept, a piece of real property used by the owner for his own purposes is subject to income taxation in Great Britain as if it were rented. The basis of taxation, whether used by the owner or rented, is the "annual value". This value normally means the full rent at which the property ought to be rented, since otherwise the income tax might be artificially decreased or completely avoided by renting the property at less than its true rent value.

This method of income taxation from real property results in a report of income without regard to

- a) the accounting method which the taxpayer may use in order to report other income,
- b) the accounting period in which the lessee may pay the rent, and
- c) the actual amount of rent which the lessee may pay.

2) *Schedule B: Income from the Occupation of Land,*

commonly called "the farmer's tax".

All occupiers of land, whether owners or not, and whether using land for profit or not, were assessed on the annual value of land up to 1940-41. At present, to the extent that the total annual value of the land is less than £100 (\$400), this principle still obtains. In all other cases, i.e. if the value exceeds £100, profits from farming are to be reported in Schedule D (see below). Farmers who have to report their profits usually keep their records on an accrual basis; however, in some cases the cash basis is still used. If cash transactions, only, are recorded a reckoning of amounts due from trade debtors and to trade creditors at the beginning and the end of the account-

ing period must be made and reflected in the accounts.

3) *Schedule C: Income from Investment in Public Funds.*

Interest from public funds (government obligations, etc.) will become taxable when it "arises", i.e. when it becomes due and payable and is actually received by the taxpayer. This kind of income, therefore, is to be reported on a strictly cash basis. In line with reporting this income on a cash basis is the provision that the income tax on interest payments is to be withheld by the debtor at the standard rate for the taxable year in which the payment is made.

4) *Schedule D: Income from Trade, Occupation or Vocation.*

In general, the accounting method to be used is the accrual basis. The profits are to be computed and ascertained through the submission of

- a) a profit and loss account,
- b) a balance sheet,
- c) a statement of the values of the plant and machinery for income tax purposes, specifying additional items, sales, depreciation (if permissible), etc., and
- d) a statement which shows the computation of profits for income tax purposes. This statement represents a reconciliation of the profit and loss amount for business purposes with such statement for income tax purposes. It shows the adjustments to the business profit and loss statement for such items as are not admissible for income tax purposes, and may be compared with Schedule M on U. S. Form 1120: Corporation Income and Declared Value Excess Profits Tax Return.

As contrasted with business firms or business men, many professional men prepare their accounts on a cash basis ignoring fees which are outstanding at the end of the accounting period. How-

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ever, for approximately twenty years the British Inland Revenue department has not permitted this basis to be applied for income tax purposes in the early years of a new taxpayer. For the first three years the tax authorities have generally required the profits, computed on a cash basis, to be adjusted by the outstanding fees. When the income of the professional man has become normalized in the sense that the outstanding fees do not vary very much from year to year, he may be permitted to change from the accrual basis to the cash basis. The income of barristers is invariably computed on a cash basis, even for the early years.

Of special interest are the principles to be applied to professional men in case of change of their accounting basis. If, after the third year of professional practice, the accounting method is changed from an accrual basis to a cash basis, the amount of outstanding claims at the close of the final year on an accrual basis will be taxed twice, once when the claim was earned (accrued) and once in the accounting period when the payment was received (*C.I.R. v. Morrison*—1932). In the reverse situation of a change from the cash basis to the accrual basis, the fees outstanding at the date of the change actually escape tax liability.

If a professional man retires from practice there is, in principle, no right to assess him later on collected fees where the cash basis has been used (*Bennett v. Ogston*—1930).

5) Schedule E: Income from Office or Employment.

Income from employment is mostly covered by a rather subtle withholding tax system. In other words, the tax on income from wages and salaries is withheld from each payment with the result that the cash basis is the only accounting basis for such income.

The accounting basis for income from the holding of an office is rather complicated but of no special interest to us.

Thus, this brief summary with respect to accounting bases shows:

a) that the *uniform* application of *one method* of accounting to *all sources of income* is not known in Great Britain (see, for U. S., Reg. 111, Sec. 29.41-2: "A method of accounting will not . . . be regarded as clearly reflecting income unless all items of gross income . . . are treated with reasonable consistency");

b) that the application of the cash basis or accrual basis of accounting depends largely upon the kind of income to be reported;

c) that the accrual basis is often not permissible as, for instance, in the reporting of interest from government obligations, the reporting of rental income from real estate, etc.; also, that the cash basis is sometimes not permissible as, for example, during the first three taxable years of professional men;

d) that there are differences with regard to the application of accounting methods even within the same kind of income, as in the different rules for farmers dependent upon whether the annual value of the occupied land is less or more than £100; also, in the treatment accorded barristers, in contradistinction to other professional men; and

e) that the change of accounting bases may involve double taxation on some items, or may yield the result that these items completely escape taxation, in contrast to the principles in Reg. 111, Sec. 29.41-2, with respect to a change of an accounting basis.

In short, in spite of apparent common general principles with respect to accounting methods, the practice looks quite different from an accountant's point of view.

II

Tax Rates

In discussing tax rates, Mr. Lieberman states that rates can not be compared because "what is taxable or de-

ductible in one country may not be taxable or deductible in the other". Nevertheless, Mr. Lieberman actually compares the tax rates (for U. S.,—1944; for Great Britain—1944-45) with the result that the following *normal tax rates* are compared:

United States
3%

Great Britain
50%
with a reduction to
32½% on the first
£165 (\$660) of
taxable income.

It is true that the normal rate in this country was 3% and that the normal ("standard") rate in the Great Britain was 50%. But this is nothing but theory. The contrasting of these two figures will, of necessity, give an erroneous impression about the relative tax burden on lower income groups in this country and in Great Britain. In order to present the actual situation it is necessary to go back to the original meaning of the normal or standard rate. It was the example of Great Britain that led us to adopt the Federal income tax and with it some typical features of the British income tax as, for instance, the division of tax rates into normal (standard) rates and surtax rates. Originally, both here and in Great Britain, the normal rate and the standard rate, respectively, indicated the *only* rate at which taxpayers, up to a specific income, were to be taxed. If the income was in excess of the specified amount, the excess was subject to a tax at the normal or standard rate *and* to the surtax rate. The nature of the standard rate in Great Britain has not changed. But our normal rate has changed considerably. To-day, as well as in 1944, the year upon which Mr. Lieberman's article is based, our normal rate has almost completely lost its original meaning. On October 15, 1945, Secretary of the Treasury Vinson stated before a Congressional Committee:

"I suggest . . . repeal of the so-called normal individual income tax. *This tax is normal in name only*". (emphasis supplied — quotation from: Hearings before the Committee on Finance, U. S. Senate 79th Congress, First Session, on H.R. 4309, part 1, page 33).

The normal tax rate was not abolished in this country. One of the reasons for keeping this rate was a promise of the Federal Government that interest on some U. S. Government obligations issued prior to March 1, 1941, would be exempt from normal tax and would be subject to surtax on a principal amount in excess of \$5,000 only. Therefore, the government found itself facing a dilemma: Either it had to follow the sound advice of abolishing the normal tax, thus depriving itself of the means of keeping its promise of a tax exemption on normal tax rates, or it had to make good the promise by carrying on with the normal tax, thus protecting the right to a tax exemption on normal tax rates.

To-day, the normal tax rate is no longer "normal" in the original sense of a basic tax on "normal" incomes. Instead, each and every taxpayer in this country is subject to the normal tax rate *and* to surtax rates*. In any comparison of the tax burden on American and British taxpayers in the lower income groups for the year 1944, one should scrupulously avoid comparing the normal tax rate in this country of 3% with the standard rate of 50% in Great Britain, unless at the same time one indicates that the normal tax rate in this country has a meaning which differs decidedly from that attributable to the standard rate in Great Britain. Actually, the minimum tax burden for 1944 was 3% plus 20%, or 23%, in this country, whereas British taxpayers were subject to a tax burden of 50%, except for the first £165, for which the tax rate was 32½%.

* The fact that in 1944 normal tax and surtax exemptions were different does not affect the systematic principle.

III Comparison of Tax Systems and its Importance

In the opinion of this writer it is important not only to compare our tax system with a foreign tax system which is applied under similar economic conditions, but also to examine the experience which the foreign country has gained from specific features of its tax system. One example, selected at random, may show the great advantages which may be derived from such research work.

Both Great Britain and this country consider a period of 12 months or one year as the basic unit for the reporting of income and the determination of income tax liability. However, such a one year basis creates hardship for a business with alternating years of profit and loss, because this business is required to pay higher taxes over a period of years than a business with stable profits, although the average income of the two firms may be equal. New enterprises and some industries, as for instance the capital goods industries, are especially subject to wide fluctuations in earnings. In order to avoid such unequal tax burdens, business losses in Great Britain may be used to offset business gains for six subsequent years. In this country, Congress, although completely aware of the aforementioned factors with respect to new enterprises and other industries with fluctuating earnings, has at different times looked upon provisions with respect to a net operating loss carry-over with alternate favor and disfavor. In 1913, no such provision was in the law. The 1918 Act originally introduced the loss carry-over provision to this country with the effect that a loss carry-over was permissible for the succeeding year. During the calendar year 1920, no loss carry-over was permitted. But the 1921 Act re-enacted the carry-over provision, this time for two successive years. The 1932 Act reduced the carry-over provision from two years to one year. In 1933, the carry-over provision was eliminated entirely. But the 1939

Act restored it for two successive years. Since the 1942 Act, for the first time in the history of the modern income tax, a carry-back of net operating loss is allowed.

However, we are not yet at the end of this story. Treasury officials, Congressmen and taxpayer-organizations vehemently dispute whether carry-over (and carry-back) provisions should be abandoned or retained or extended (Hearings before the Committee on Finance, U. S. Senate, 79th Congress, First Session on H.R. 4309 and "Tax Reduction by Carry-backs and Carry-overs by H. Landman in The Journal of Accountancy, April 1946, p. 282 ff.). In "A Program for Federal taxes as proposed by the National Association of State Chambers of Commerce", this association proposes to extend the net loss carry-over provision from two years to seven years. The carrying into effect of this proposal would create a situation very similar to the present situation in Great Britain. But before changing the law again and again, why should we not endeavor to examine the economic effects of this provision in Great Britain, whether there are complaints of a serious character, the nature of these complaints (if any) on the part of taxpayers or on the part of the Government, the loss of revenues to the Government which is connected with the extension of the carry-over provision, and so forth. Of course, we should also examine whether there are reasons for concluding that the British experience in this connection may not be applicable to this country.

In any case, the knowledge of the British tax system and the utilization of the experience of the British people who, for more than a century have been in advance of other nations in the scientific and practical application of taxation, may be of great importance in avoiding unnecessary experiments and in thus securing the faith of the taxpayer in the predictability and straightforwardness of our tax policy. For this reason, this special field of research work can hardly be overestimated.

Proceedings at the Dinner in Honor of the Members of the Society who Served in the Armed Forces of World War II

May 13, 1946

President Donaldson: Members of the Society, and especially you, our honored guests, the returned veterans: Tonight is a big night in the history of our Society. In its nearly fifty years of life we have never previously had a celebration of this character. It is indeed fitting and timely that we assemble on this occasion to honor you men who have returned to us to pick up the threads of life where you left off when you joined the ranks of Uncle Sam's fighting forces. You are all too close to us, too much a part of our great State Society, for me to launch into fulsome praise and flowery commendation. That is embarrassing in the inner circles of the family. We know you will enjoy yourselves much more among your professional friends around the table if we omit saying many of the things we feel in our hearts and that you know rest there for you tonight.

Suffice it to say that while those of us who stayed at home played the parts in the production line we were called on to assume, you were the ones who made the sacrifices; you were the ones who gave up your liberty of movement to undertake the hardships and miseries and lonesomeness of war; you were the ones who "took it" for us back home.

We now welcome you back!

We greet you as warriors. We want to do all we can to cooperate with you to reestablish yourselves in the niches of life where best you fit—where you will be the happiest. I am sure you will find that your friends in the profession, your fellow-members, are just as anxious to help you to do what they can, personally, to produce that result.

I am sure you do not want to forget your experiences, sacrifices and hard-

ships entirely, and certainly not the many fine new friends you have made in the services. Some episodes perhaps you would like to shut out of your consciousness but many of them are worth reliving and will be relived as the years go on.

And now that you are back, many of you, I know from the Society's records, have picked up your ways of life in the exact spots that you occupied before you went into service; but there are many others who feel that they will be happier and make more progress if they embark on new attachments or new lines of endeavor.

You will be very interested to know that, through our Society's placement service, in the last six months we have located jobs for 226 veteran members of the Society, and we have directed many other members to sources of employment but we do not have statistics of those other jobs. This is just one example of what we are doing and will continue to do for the veterans. You might also know that, in the past six months, we have placed 101 other veterans, not members of the Society, in accounting jobs.

Supplementing the book "Contemporary Accounting" which we made available to veterans at greatly reduced cost, we are now launching the refresher course. This is exclusively for veterans and will be conducted on a senior level. We waited for the end of this month to open up this course, for two reasons: First, because we wanted to have the maximum number of returned veterans home, ready to take the course; second, we wanted to wait until the pressure of the season lifted so those attending would have few

Proceedings at Dinner in Honor of Members Who Served in Armed Forces

interruptions and absences. This is a great opportunity. We have over 150 veterans already registered to take this course, and those of you who have not yet sent in your reservations are urged to do so because we want to get the proper room to house you where the acoustics will be good, since half of each session will be devoted to discussion. So please get in your registrations. The first three or four lectures will whet your appetites, I am sure, and you will carry on enthusiastically to the end.

The best tribute the Society can pay you, as veterans, I believe, is simply to receive you back again and to cooperate with you to the maximum to make up for the time and things you lost during your enforced absence from us during those difficult and saddening war days.

That is the extent of the message I have for you, and now we have chosen one of the Society's veterans to speak for you. We had quite a job to figure out who, of our 900-some-odd who were in service, should do that; but our committee worked out a special little formula and, when we applied it, lo and behold the one man who met all the requirements of the formula is the one who will speak to you tonight: Mr. Moore P. Huffman.

Mr. Moore P. Huffman: Mr. Donaldson and members of the Society. The veterans have been welcomed back to the inner circle of the family by Mr. Donaldson most warmly and we all respond sincerely to Mr. Donaldson's straightforward words. Likewise, we can say that we are glad to be back—very glad to be back—and we return with a deep appreciation and a keen awareness of the roles played so well by those whose duty it was to remain in the country in connection with the production of war material.

In the recent war, as in no other war in history, the entire economic and industrial strength of the country was marshalled in order to afford the Allies the means and the materials to force the

war to a successful conclusion. That this happened when it did was due to those of you who, in uniform and out, directly and indirectly, assisted in this tremendous work of production; and, as I said, those of us who were assigned to other duties will not forget this.

In returning, we are likewise cognizant of your readiness to assist us to reeducate and reorient ourselves professionally. As members of the profession it is our duty to accept the helping hand which the Society has extended in the manner to which Mr. Donaldson has referred. We must now prepare to do our part in solving the problems left by the war, in simplifying the complexities, and in curing the dislocations.

President Donaldson: When we chose Mr. Huffman to talk to you, he kept telling us he is not an orator. We told him that wasn't why he was selected. If you will look up the war roster which you received tonight you will see "Moore P. Huffman, Commander, U.S.N.R., Line." He went into service an Ensign in 1941. And you will note, tucked away there, that he received high combat awards: The Silver Star and the Presidential Unit Citation. That is why, as our most highly decorated combat veteran, we have selected him to speak to you tonight.

There were nine men who did not and will not come back, for they have given their lives in the service of their country. The roll of our honored dead appears in the record of war service that you have before you. I am going to call that roll:

Charles A. Daum
Richard C. Whitelocke
Irving Levine
William Goros
Alexander I. Saladuchin
William Combrinck-Graham
Jack I. Hauser
Leo Taub
Vernon L. Denby

These are the men to whom all tribute is due: our absent members, called

by the will of God to their eternal and glorious destiny.

Of their supreme sacrifice let us prayerfully reflect for a minute, before Major Hall, chaplain of the Army of the United States, speaks of their contribution to victory.

—A moment of silence followed—

Chaplain (Major) Robert S. Hall:

We in America are motherworshippers; we are not worshippers of Mars. These honored dead gave the last full measure of their devotion to the motherhood of their country.

You have a supreme example before you tonight of the thing for which these men fought and bled and died. No one is going to tell you how to vote: that is your privilege; and, let any man on the face of this great earth challenge your right to express yourself in free speech, you will rise in arms to defend that given power.

It is very fitting that the day after Mother's Day we pay tribute to these honored dead, for, in the year 1908—on that second Sunday in May—a little lady paid tribute to her mother with the giving of white carnations to each individual who came within the congregation of that church, for the white expressed Virtue and Honor and Fidelity. Each of these honored dead received, from the knees of their mothers, those same virtues.

Will you listen to this tribute

Our honored dead, you gave your spirits, blending them with your fellows for all mankind that we might have two dwelling places: on earth an earthly fatherland and a City of God.

You honored dead, you knew you were guests but for a time, but were builders of that other Place. To the one you gave your lives and faithful hearts; but neither family nor friend nor fatherland nor aught to be loved above the Power and the Spirit which is Light—the Light of your Lives.

You felt your duty to rise above

tempests and thrust aside the clouds which threatened to obscure your Motherland. You felt that inner impulse to build higher and stronger, dominating the injustice and hatreds of nations, until the walls of your Sacred City, your Homeland, were builded of the souls which make democracy eternal.

May you live in glory and in peace in the life eternal!

President Donaldson: I am sure we appreciate the very splendid spiritual sentiments given to us by Chaplain Hall. And let us remember, as the years go by, that as our recollections of the war and the part we played in it grow dimmer and dimmer in our own minds when we are talking to our grandchildren about it—let us always remember the part that our profession played, not only on the field of combat but also back in the fields of finance, accounting, renegotiation and other matters that seem so important and necessary in modern warfare.

You have a beautiful souvenir tonight: a list of all of those who gave that service. Preserve it, keep it in your archives; let it be part of your history. Those of you whose names are there, bring it out for your grandchildren; let it be there in your library when you go yourself to look over your books.

And let us all pray, before we officially close our tribute to the veterans, that those who represent us in the United Nations Organization and those in Paris who are trying to work out the principles of peace—let us all pray that they, with the help of God, will work out some kind of plan, some kind of program, whereby none of us—our children or our grandchildren and the many generations to come—will ever have to go through what we have gone through during the last five years and suffer what the nations all over the world have suffered, even more so than we have suffered in our own country.

PROFESSIONAL COMMENT

By EMANUEL SAXE, C.P.A.

The Uses and Classifications of Cost

The Committee on Research of the National Association of Cost Accountants has recently published a preliminary background study in a research series to be devoted to problems of industrial accounting, which broadly outlines the entire field of cost accounting and its many and various subdivisions, and which is intended to serve as the basis for planning and integrating all future research projects involving specific delimited areas of investigation (*Research Series*, No. 7; May 15, 1946).

Cost accounting is essentially an extension of general accounting procedures whereby cost-incurring transactions are further classified and analyzed into those cost patterns which are necessary to intelligent industrial management.

This study recognizes that cost information is used by management for a variety of purposes and that not all of them are served equally well by the use of the same data. The paper indicates the ways in which management utilizes cost data in response to specific needs; it suggests the type of cost data believed to be most appropriate in each such case; and it points out certain of the accounting problems involved in the ascertainment of such costs.

The following uses of cost data are stated and discussed:

1. *Profit determination and inventory valuation*, by the use of historical costs.
2. *Budgetary planning*, with the aid of the forecast budget, which tabulates the best possible estimate of expected

actual costs in virtually the same fashion as the historical income statement.

3. *Cost control* through the establishment of standards of expected performance which control costs either through the identification of individuals responsible for their incurrence, or through the elimination of wasteful variances disclosed in the accounts after manufacture has been completed.

4. *Pricing policy*, which involves the determination of long-run normal product costs to make and sell, with special recognition of cost differentials arising from different marketing and delivery methods.

5. *Current applications of plans and policies*, which require a knowledge of such expected actual cost data as are necessary to make the daily decisions with respect to such managerial problems as whether to make or buy a component part, to accept or reject business offered at a special price, to substitute materials, etc.

We await with great interest and expectation the more detailed exploration and study of the various areas of interest staked out for us in this preliminary report.

Types of Costing Systems

On January 21, 1946, R. G. Jackson, A.C.A.A., delivered a lecture before the members of the Australian Institute of Industrial Management Cost Control Group. This interesting lecture was reported in the March, 1946, issue of *The Australian Accountant* under the foregoing title.

Under the heading of *Historical Costing Systems*, the author discusses at length Specific Order costs, Batch costs (which is a variation of specific

order costs), Process costs, and Unit or Operation costs. Standard Cost systems and Estimated Cost systems likewise receive extended treatment.

For one who desires a quick and comprehensive review-outline of the subject matter evidenced by these titles, a perusal of this article is recommended.

Internal Control and Internal Auditing

An interesting joint discussion took place in the columns of *The Comptroller* in the May, 1946, issue. Maurice E. Peloubet presented the viewpoint of the certified public accountant, and Victor Z. Brink presented the standpoint of the company.

Mr. Peloubet's presentation concerned itself with the attitude of the public accountant toward internal control and internal auditing. He quotes the applicable provision of the Securities and Exchange Commission's Regulations S-X (Rule 2-02). He points out that if the independent auditor is to give the fullest possible weight to the work of the internal audit staff, he must satisfy himself that the staff is composed of able men with adequate training. He must determine that it functions freely and independently, that its programs and methods are properly devised and effectively executed, and that it reports to a responsible official sufficiently removed from the transactions themselves to be sure that he will possess a sufficiently objective viewpoint. The critical examination of the internal audit program, the careful perusal of internal auditors' reports, and the test to see if the internal auditors actually do the work which they are instructed to do,—all requires the expenditure of time as well as the exercise of professional skill and judgment; it is probably one of the most important parts of the audit.

Mr. Peloubet observes that the relation between the independent auditor and the internal auditor is more or less parallel to that existing between two accounting firms, one of which is doing

the work which the other firm is willing to accept after satisfying itself as to the responsibility and reliability of its correspondent. The requirements of generally accepted auditing procedure, as well as those specified by the S.E.C., admit of reliance upon the work of the internal audit staff and of the preparation of schedules and statements by clients. However, the S.E.C. would seem to regard it as improper for the auditor to request the client's bookkeeper or even the client's internal auditor to assist in making a specific check of some record, although it is apparently correct to accept similar work when done as part of the internal audit work.

*Mr. Brink states and discusses the following basic principles of internal control:

- (1) The working out of checks and balances as a part of the procedures.
- (2) The establishment of a proper organization.
- (3) The current review of operating procedures in the light of existing conditions, no matter how skillfully designed in the first instance.
- (4) An intensive follow-up of all indicated deficiencies in the internal procedures.

The principal means available to management in the development of good internal control within the company organization is the establishment of a good accounting system. Of course, decisions have to be made as to what transactions should be identified, and in what detail; what assets merit protection, and to what extent. Also, as to how information should be classified and summarized, and how it should be made available.

These decisions must in a main precede the actual formulation of the accounting procedures, as such. Then the accountant is in a position to develop the specific forms and procedures by which the transactions involved can be

identified and recorded and by which the subsequent accumulation and classification of the data can be carried out to make the information available for current reference and in needed reports to management.

The second important technique is the development of manuals or other clear, written media which set forth distinctly and precisely the organizational responsibilities and the important company policies. These require management to clarify its own thinking and also to provide a written record which is available for the guidance of those directly and indirectly involved.

The third item is good budgeting. The fourth, the setting up of a good personnel department.

In view of the fact that management rarely has first hand contact with actual operations it has found it increasingly advantageous to make use of a new agency, the internal auditing department, to bridge this gap and to serve as an independent check on the accounting and other operations of the organization.

The internal auditors, according to Mr. Brink, should be directly responsible to the Board of Directors. In this fashion they have the authority and the independence to reach any conclusion which the facts in a particular situation make proper and necessary.

Report of A.I.A. Committee on Auditing Procedure

The Reports to the Council of the American Institute of Accountants (May, 1946) contain the report of the Committee on Auditing Procedure, the more important elements of which may be summarized as follows:

A sub-committee has undertaken the work of developing a statement with respect to the nature of auditing standards and has presented a preliminary statement relating to the classification and definition of auditing standards in the areas of (a) General Standards

(b) Standards of Field Work, and (c) Standards of Reporting. This report is not yet ready for release.

Another sub-committee has been continuing its consideration of the revision of the language and terminology used in the certificate form approved by the committee in 1941, and reported in Statements on Auditing Procedure No. 5. Various suggestions have been received leading to a change in that certificate, and the work of the sub-committee is now concerned principally with an integration of these suggestions for revision of the certificates with the conclusions to be expressed in a basic statement on auditing standards.

Still another sub-committee is continuing its study of the subject, "Reporting Transactions and Events Occurring Subsequent to the Close of the Fiscal Period."

The ultimate outcome of these studies by way of completed reports is awaited with a great deal of interest.

A New Form for Projecting Financial Statements

Accountants who are interested in ascertaining how the credit granting officer of a bank follows up the progress of their clients between statement dates, will derive much valuable information from a study of this article which appears in the May, 1946, Bulletin of the Robert Morris Associates.

The form is designed to provide the loan officer with current information as well as with the basis for forecasting and evaluating the future business prospects and credit needs of the borrower-client. It is not an involved statement; indeed, it should be prepared fairly easily and accurately by anyone with a moderate knowledge of bookkeeping or accounting. The borrower merely prepares a simple work sheet form; the rest of the statement is completed at the bank by the loan officer.

Accounting for the Construction Industry

The construction industry is now one of the major industries of the nation and one which will undoubtedly occupy a front rank position for some years to come. It is the subject of a short article, covering the high spots of construction accounting, appearing in the June 15, 1946, issue of the N. A. C. A. Bulletin and written by Roy M. Abagnale, C.P.A., who was formerly a member of our Society's Committee on Construction Contractors' Accounting.

The basic accounting records, the equipment operating cost ledger, the job cost record, and the contract ledger are first discussed. Next, the two bases of accounting (the completed contract method and the accrual or annual method) are briefly considered. Some special features of the following accounts, Accounts Receivable, Inventories, Deposits, Fixed Assets, and Deferrals, are then presented with reference to their use in this field of activity.

The various methods generally used by contractors in the determination of profit or loss under the accrual method of accounting are outlined in some detail. These include:

1. Billings less costs to date;
2. Costs plus a percentage of profit;
3. Percentage of completion;
4. Percentage of cost of operation; and
5. Cost accounting.

Note is also made of the importance of the subject of overhead costs in this industry, which is not discussed because of its size and complexity.

Standards of Disclosure

The Accounting Research Committee of The Dominion Association of Chartered Accountants has reviewed "A Tentative Statement of Standards of Disclosure in Annual Financial Statements of Manufacturing and Mercantile

Companies", and is considering its issuance in the near future as a promulgation of the committee. However, before doing so it has afforded members of the profession the opportunity to study and comment upon the statement by publishing it in the June, 1946, issue of the Canadian Chartered Accountant.

Attention is directed to the fact that this submission deals only with minimum standards of disclosure, and "is not intended to have any connection with the accounting principles and procedures which are involved in the determination of the figures" shown in the statements. It is also pointed out that the standards set forth "are not to be construed as the substitutes for the exercise of judgment where further disclosure is necessary to avoid ambiguity or to prevent a statement from being misleading."

Two important principles set forth at the outset are: "(1) Amounts which are not significant in degree need not be shown separately. * * * (2) The financial statements should be read as a whole and notes appended thereto for the purpose of clarification or further disclosure are considered to have the same significance as if the explanations were placed against the items concerned. * * *"

Specific recommendations follow next with respect to disclosure in the annual financial statements.

Under the heading of Consolidated Statements the point is made that the standards of disclosure discussed in the body of the article apply equally to consolidated statements. Further, that where consolidated statements are submitted, the basis of inclusion must be set forth and they should clearly indicate which subsidiaries have been consolidated and which, if any, have been excluded. The details with respect to the latter should of course be appropriately disclosed.

The Statement continues as follows:

"The total equity of minority shareholders in the capital and surplus of subsidiaries should be shown separately and if preference shares are outstanding then

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the minority interest in these should be segregated. The interest of minority shareholders in the profits or losses for the year should be deducted as a separate item in the statement of profit and loss.

"The difference between the cost of the shares in the parent company over its equity in the net assets of subsidiaries at their dates of acquisition should be shown separately on the balance sheet grouped with good will unless such difference has previously been disposed of by a procedure disclosed in the annual statements of preceding years.

"If certain subsidiaries are consolidated as of a date different than the date on which the holding company closes its accounts, disclosure should be made of the dates as of which their accounts have been included unless their assets or earnings are not significant in relation to the relevant totals for the group."

Under the heading of "General Comments" the statement is made that if, during the period under review, important changes in the company's accounting procedures have taken place which have a material effect upon the income statement then, of course, the nature of the change and, if practicable, the effect thereof upon the results disclosed in the financial statements should be set forth.

It is stated that under ordinary circumstances, annual statements should be presented on a comparative basis so as to make the figures of the preceding year and those for the current year available side by side.

Accounting Partnership Profits Paid to Deceased Partner's Estate

Our readers will recollect that a recent article by Mr. Max Block, a member of the Society, discussed the interesting subject of good will in connection with professional partnerships. In a recent Tax Court case (*Coates*, 7 T.C., #17) the surviving members of a firm of accountants, pursuant to their partnership agreement, paid a participation in their profits to the estate of a deceased partner for five years after his death.

The Commissioner contended that

the partnership agreement in this case effected a sale of the interest of the deceased partner in the capital and good will of the old firm, under the doctrine of *Bull vs. United States*, (295 U.S. 247).

The Tax Court indicated in this case that this doctrine will generally not be applicable to professional or other personal service partnerships, wherein the capital is usually nominal and where ordinarily no value can be ascribed to good will. The rationale of the holding was that the instant agreement permitting the estate to continue to participate in the profits did not indicate an intent to make a sale thereof.

Accordingly the profits accruing after the death of the deceased partner and payable to his estate were taxed to his estate and not to the surviving partners.

Disclosure of Income Tax Liability of Partners

Anent the question and comment appearing in these columns in the May, 1946, issue on the question of whether or not it is necessary to disclose the liability for Federal income taxes due by the principals of a partnership in the auditor's report on the partnership, it will undoubtedly be of interest to our readers to learn that the problem is still receiving continued debate in various circles.

For example, in the May, 1946, issue of the Credit Executive, the most important credit problem of 1946 is there reported to be the question of the statements of individuals or partnerships who show profit and do not indicate whether the taxes have been paid thereon or what the amount of such tax liability is.

In another magazine, Credit and Financial Management for April, 1946, a letter to the Editor reaches substantially the opposite conclusion. Only if large withdrawals were actually made subsequent to the balance sheet date but prior to the audit date, would this

correspondent append a note to the balance sheet disclosing the fact, and then only if they would substantially change the financial position of the company.

Cost Control Possibilities in State Unemployment Insurance Taxes

Attention is directed to a very illuminating article by B. W. Roberts, appearing in the June 1, 1946, issue of the N. A. C. A. Bulletin, which considers various cost control possibilities inherent in the merit rating plans recognized under the several state unemployment insurance tax laws. This paper will be of particular interest to accountants serving clients in other states, since it discusses the following four general merit rating classifications, extant in 41 states (not including New York, which has its own individual experience rating plan) and the District of Columbia.

1. Reserve Ratio Formula (26 states and D. C.)
2. Benefit Wage Ratio Formula (8 states)
3. Benefit Ratio Formula (6 states)
4. Compensable Separations Formula (1 state)

The author asserts that material savings are available to those willing to study this variable expense item carefully.

New Tax Regulations Regarding Non-Business Expenses

Regulations 111 have recently been amended by T.D. 5513, to the general effect that reasonable amounts paid or incurred by fiduciaries for ordinary and necessary expenses in connection with the administration of estates, trusts or receiverships, are deductible as non-business expenses. This amendment to the regulations is retroactive.

A second change now permits deduction for all expenses paid or incurred by an individual in the determination of a liability for taxes upon his income.

This amendment apparently applies to all reasonable expenses incurred in connection with all types of income tax returns, and would seem to permit deduction for fees paid for preparing tax returns, expenses incurred in connection with the review thereof by governmental agencies, and amounts paid for tax advice in connection with transactions not yet consummated.

Competition of Cooperatives with Other Forms of Business Enterprise

The United States Government Printing Office has recently released the first interim report by the Committee on Small Business of the House of Representatives, based upon a study and investigation of the charge that cooperatives have been enjoying a full or partial tax exemption privilege and other alleged favors, which constitute a threat to private enterprise. Hearings were held by the Committee and were supplemented by the considerable amount of research undertaken by members of the Committee and its staff subsequent to these hearings.

The following conclusions were reached and stated (from among others) in the report:

Tax-exempt farmer cooperatives apparently do have an advantage over competitive businesses operating in the same fields to the extent that amounts of income available for the payment of dividends on capital stock and accumulated in reserve for the use of the cooperative for its corporate operation escape Federal income taxation. * * *

It does not appear that the tax exemption available to exempt farmer cooperatives has any true bearing upon any competitive advantage which the cooperative might have in its normal operations.

Agricultural cooperatives which are non-exempt from Federal income tax and all consumer cooperatives apparently enjoy no privileges or advantages under the tax laws which are not available to all other types of competitive businesses operating in the same lines of endeavor. It seems readily apparent that non-cooperative business agencies, if they are willing to render services at cost, would not be subject to any income tax.

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Since non-exempt cooperatives are subject to all of the taxes normally assessed against comparable non-cooperative organizations it appears that to tax the income of a cooperative would require a drastic change in the basic principles of our revenue laws. The Bureau of Internal Revenue has ruled, and the courts have upheld, the principle that the cooperative entity serves only as an agent for and on behalf of its members, and that at no time does its income belong to other than its members. Since the apparent intent of the Congress in levying taxes has been to levy on ability to pay, it does not appear to be reasonable or equitable to attempt to levy a tax on a cooperative for income which does not belong to it nor to levy a tax for which it has no funds to pay. The levy of a receipts tax on such a cooperative would probably raise constitutional objections. Such a tax would have to be levied against all types of organizations which have income, which, by virtue of their charter, does not belong to them as an entity, but which belongs in a non-profit sense to their members. Such a tax would seriously affect schools, churches, charitable and scientific organizations, and many social clubs which have a comparable advantage of tax exemption.

There is substantial evidence to show that the cooperative movement operates as a very successful means of combating monopolistic concentrations and, as such, is a very healthy addition to the American economy.

The theory that the cooperative move-

ment is seriously endangering other economic forms of business operation can be utterly disregarded inasmuch as the volume of business enjoyed by cooperatives and their degree of participation in the national income is very nominal.

New York State Franchise Tax Accrual

In preparing their 1945 Federal income tax returns, most corporations operating in New York State undoubtedly claimed as a deduction from income an accrual for the New York State Franchise Tax, computed at the then existing rate of 6%. Subsequent to March 15, 1946, the New York Legislature decreased the rate of this tax to 4½% (Laws of 1946, Chap. 110).

Since the Treasury has recently ruled that this franchise tax can be accrued only at the 4½% rate, it is incumbent upon corporations who have already filed these returns with a deduction based on the previous 6% rate, to recompute their tax liability and make payment of the difference resulting from the consequent increase in income. To avoid unnecessary interest penalty the increase in tax resulting from this adjustment should be paid as soon as possible.



The Internal Auditor's Control Function

It is noteworthy that the value to management of control function as exercised by the internal auditor, increases in geometric proportion to the degree of competence of the man who heads it and in like proportion to the degree that the function is divorced from incompatible and superimposed authority and interference. The competent internal auditor should be a man appointed by and directly responsible to the board; while, at the same time, the department is essentially a service function, charged with the duty of cooperating with all other functions of the business, by helpful guidance through the interpretation of financial results and trends. Mere routine validation of actual expenditures is only the elementary purpose of internal accounting control and internal auditing. The value of the function mounts by leaps and bounds as it takes on the stature of a reliable source of guidance for future policy, through the interpretation of financial data.

VICTOR H. STEMPF
(The Internal Auditor—June, 1946.)

BOOK REVIEWS

Instalment Mathematics Handbook, with working formulas for all types of transactions, by Milan V. Ayres—Consulting statistician; member of the Massachusetts bar; formerly analyst and general manager, National Association of Sales Finance Companies, and analyst, American Finance Conference. THE RONALD PRESS Co., New York, 1946, \$10.00. Pages: xvi+267.

The author, in his preface, says, "Everyone responsible for making the many recurrent calculations required in the time-payment transactions involved in loans, the financing of instalment sales and similar activities soon feels the need of a special work on the practical problems of instalment mathematics. The variations of his individual problems are not covered in available tables. The general book on business mathematics and finance must stay within limits in its explanations and illustrations of specialized problems. Specific additional information is required covering the problems of the instalment field. This Handbook has been written to give comprehensive and detailed information which will enable the user readily to make reliable time-payment calculations."

Certainly Mr. Ayres, from his vast experience in this field, is in a position to recognize the needs therein existing and in this Handbook he has adequately satisfied those needs.

In Part One he has presented all the formulas of instalment finance without

derivation or proof but with careful definition of terms, meticulous listing of symbols used, and with illustrative examples giving the applications of these formulas to the practical problems of the field. The formulas are carefully arranged, numbered, and captioned to make this section eminently usable in practice. Included among the many problems covered are those of: the ordinary instalment contract; the balloon note contract, in which a series of equal instalments is followed by one larger payment; interest bearing instalment contracts; insurance premium financing; Morris Plan loans; loans under small loan laws; hold-back deals, in which the finance company "holds back" a portion of the purchase price of an instalment contract until some stated condition is fulfilled; operating costs; distribution of earnings; computation of rate charts; rebates for prepayments; and limitations on bank borrowings of finance companies. Six tables are included in this section for use with certain of the formulas involving yields, charges, and rebates. Formulas for interpolation in these tables are also presented.

Part Two gives the derivations, discussion, and proofs of all the formulas set forth in Part One with further discussion of practices, methods, and problems in the field. While the derivations and proofs of the formulas are not those of a rigorous work on mathematics they are adequate and can be easily followed with very little dependence on other than simple arithmetic

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and algebra. A very complete picture of the field of instalment finance is brought forth in this section making the formulas of Part One very meaningful.

In dealing with equivalent interest rate or yield, Mr. Ayres advocates and uses the "Uniform Method" which considers that a constant fraction of each instalment payment is charge. He feels that this is the simplest and best method for practical use but he also presents the other methods in use and discusses the controversies which exist over which method is "correct." While the treat-

ment of this topic leaves something to be desired, it is considerably better than the usual discussion of this really difficult problem.

All in all, I consider this a very sound book, extremely useful in its immediate field and widely interesting to even remotely related fields.

RUSSELL D. LOUCKS

Department of Mathematics,
The School of Business & Civic
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Verify the Signature!

In testifying before the Referee in Bankruptcy under 21-A proceedings, a bankrupt, whose affairs have attracted nationwide attention, made one interesting admission. A financial statement had been submitted to his creditors on the letterhead of his accountant bearing the accountant's signature. The accountant testified he had never issued or signed it. The bankrupt testified that he stole the accountant's letterheads, typed in the statement and forged the accountant's signature!

MORTIMER J. DAVIS
(Credit Executive—June, 1946.)

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